



Payroll Tax Cuts as an Economic Stimulus Response to Coronavirus Disease (COVID-19)

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The current coronavirus disease (COVID-19) outbreak has increased concerns that the U.S. economy could be affected as part of a [global economic downturn](#). A range of [fiscal](#) and [monetary policy](#) tools have been used to address prior times of economic weakness. One option for fiscal stimulus is a temporary payroll tax cut for employees. This option was used to address economic weakness in 2011 and 2012. On March 2, 2020, [President Trump](#) and [others](#) expressed interest in a one-year payroll tax cut to help bolster the economy.

What Are Payroll Taxes?

Payroll taxes are collected to finance certain entitlement programs, including [Social Security](#), [parts of Medicare](#), and [Unemployment Compensation \(UC\)](#). Social Security's old age, survivors, and disability insurance (OASDI) payroll tax is paid by eligible workers and their employers, and it finances the [Social Security trust funds](#). The tax equals 6.2% of wages on the taxable earnings base ([\\$137,700 in 2020](#)). This tax is paid by both employers and employees (with self-employed individuals paying both the employer and the employee share, or 12.4%).

Stimulus Effects of a Temporary Reduction in Payroll Taxes

Short-term fiscal stimulus measures aim to boost economic activity primarily through increases in the demand for goods and services. The Congressional Budget Office (CBO), [in testimony before Congress](#), previously identified three key criteria commonly used to assess the stimulating effects of policy

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proposals: (1) timing, (2) cost-effectiveness, and (3) consistency with long-term fiscal objectives. The following sections evaluate a payroll tax rate reduction using these criteria.

Timing

To be effective, short-term stimulus should affect the economy while it is in a period of economic weakness. Although there is general agreement that the coronavirus will have dampening effects on the U.S. economy, there is substantial uncertainty regarding the magnitude of these effects. The [Federal Reserve Federal Open Market Committee decision to lower the federal funds rate by half a percentage point](#) is indicative of the risk the coronavirus poses to the economy. Many fundamentals of the U.S. economy, however, remain strong. Unemployment is at its lowest level since the 1960s, consumer spending is strong, and the economy remains in its [longest period of economic expansion](#). Some [Members of Congress](#) and [other commentators](#) have expressed skepticism regarding fiscal stimulus in the form of a payroll tax cut as a coronavirus response. Others believe the situation [warrants an immediate response that includes some form of fiscal stimulus](#). Relative to most other forms of fiscal stimulus, a payroll tax cut could be implemented relatively quickly. It could also be designed to expire as the economy strengthens.

Cost-Effectiveness

Effective short-term stimulus maximizes the increase in output and employment per dollar of budgetary cost. This is often colloquially referred to as the policy's "bang for the buck." Economists more often use the term [multiplier effect](#). The multiplier effect of a fiscal policy depends on the [fraction of additional income spent](#), as opposed to saved, on goods and services relative to the lost federal revenue. Provisions targeted at low-income individuals or the unemployed often are expected to be more cost-effective—have larger multiplier effects—than broad tax rate reductions, as those facing financial constraints are more likely to fully spend any additional disposable income.

Considering the source of the economic weakness can inform analysis of the likely effectiveness of a payroll tax cut. A payroll tax cut does not address supply-chain disruptions and might have limited effectiveness if the economy were positioned to snap back on its own after the shock—referred to as a [“V-shaped” economic disruption](#). If, however, the coronavirus-induced economic slowdown leads to layoffs, reduced hours, or reduced consumer spending, a payroll tax cut could help offset reduced demand.

A 2015 [CBO working paper](#) presented data suggesting that multipliers vary according to the strength of the economy—with the smallest multipliers occurring when the economy is at or near full employment. A payroll tax cut enacted in a strong economy likely would have [less “bang for the buck.”](#) Currently, the coronavirus does not appear to have caused widespread economic damage, and [a statement from the G7 Finance Ministers and Central Bank Governors](#) affirmed a readiness to respond if economic conditions deteriorate. As noted above, however, the situation is evolving.

Consistency with Long-Term Fiscal Objectives

Effective short-term stimulus should not hinder long-term fiscal sustainability. Any reduction in payroll taxes, by itself, adds to short-term budget deficits and could be at odds with the long-term goal of debt sustainability. This is a consideration given that the [budget deficit and federal debt are higher than their historical averages](#), relative to the size of the economy.

To [address long-term fiscal objectives](#), a temporary reduction in payroll taxes could include offsets to reduce or eliminate the net budgetary cost of the proposals. Offsets are, by definition, contractionary, as they either cut spending or raise taxes—though the timing of the offsets could be designed to apply their contractionary effects in later years.

In the past, the effect of payroll tax cuts on federal tax revenue has been substantial. The temporary payroll tax cut effective for 2011 [reduced federal tax revenue by \\$111.7 billion](#). The two-month extension for early 2012 [reduced federal revenue by \\$20.8 billion](#), and extending the payroll tax cut through the remainder of 2012 [reduced federal revenue by \\$93.2 billion](#). When payroll tax cuts were used as economic stimulus in 2011 and 2012, the Social Security trust fund was “made whole” by a transfer of general revenue.

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