



Independent Fiscal Office

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How Will the Proposed Extension of the Payroll Tax Cut Impact the PA Economy and Tax Revenues?

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INTRODUCTION

Throughout 2011, workers received a boost in their take-home pay due to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. That Act temporarily reduced the payroll taxes that employers withheld from employee paychecks and remitted to the federal government. On December 23, 2011, the President signed the "Temporary Payroll Tax Cut Continuation Act of 2011." That Act extends the payroll tax cut for two months through February 2012. The House and Senate have convened a bi-partisan committee to examine methods to extend the payroll tax cut for the full year.

How will the proposed extension affect Commonwealth residents and tax revenues for the current and subsequent fiscal years?

BACKGROUND

The Federal Insurance Contributions Act tax (FICA, also known as the payroll tax) has two parts: (1) the old age, survivors and disability insurance (OASDI) tax equal to 12.4 percent of covered wages and (2) the Medicare hospital insurance (HI) tax equal to 2.9 percent of covered wages. Covered wages are all remuneration for employment paid to employees covered by the Social Security system. The OASDI tax is levied on covered wages up to certain thresholds: \$106,800 for 2011 and \$110,100 for 2012. The HI tax is levied on all covered wages. Employers and employees each pay half (6.2 percent of OASDI and 1.45 percent of HI) of total FICA taxes. The employee's share is withheld from wages and remitted to the federal government by the employer, along with the employer's share. The payroll tax cut reduced the employee's OASDI tax rate by two percentage points, from 6.2 to 4.2 percent. (Self-employed persons pay a similar tax that is generally equal to the employer and employee portions of FICA. That tax was also reduced by two percentage points.)

ANALYSIS

It is relatively straightforward to project the general impact of the proposed tax cut extension on the Pennsylvania economy and tax revenues. Data from the Social Security Administration show that in 2008, Pennsylvania

residents and businesses remitted \$29.2 billion in OASDI payments to the federal government.¹ Wage data suggest those payments might increase to roughly \$30.7 billion (5 percent) by 2012 if “normal” tax rates were applicable. The proposed payroll tax cut reduces the total OASDI rate levied on employers and employees by 16.1 percent (2.0 / 12.4), and a full-year extension of the payroll tax cut would reduce contributions (and increase disposable income) by approximately \$5.0 billion for Commonwealth residents. A ten-month extension would reduce contributions by \$4.1 billion. (See table.)

An extension of the payroll tax cut would also impact General Fund tax revenues. Research suggests that recipients might consume anywhere from 30 to 90 percent of a temporary tax cut or rebate, while the remainder would be saved or used to pay down debt.² If recipients spend 60 percent of the tax cut extension (and the spending does not “leak” outside of the state, although non-resident purchases could also flow into the state), then purchases would increase by \$2.5 billion. Personal Consumption Expenditure data from the National Income and Product Accounts suggest that roughly 50 percent of total expenditures might be spent on items subject to

Pennsylvania sales or use tax, generating \$74 million of additional sales tax revenues.³ Additional General Fund tax revenues would also be generated through higher personal income and corporate income tax collections since the additional spending increases the profits of business owners. However, data are not available regarding the average profit margin per dollar of sales for Pennsylvania businesses. If one assumes an average profit margin of five percent, then the additional purchases could generate \$125 million of business income. That income would be taxed at the individual tax rate for pass through entities such as partnerships, S corporations and sole proprietorships (3.07 percent) or a corporate tax rate (9.99 percent) for C corporations.

Extension of Federal Payroll Tax Cut	
millions of dollars	
PA OASDI taxes paid, 2008	29,242
PA estimated OASDI taxes, 2012	30,704
Reduction to OASDI tax rate	-16%
Full-year impact on disposable income	4,952
Impact if extension passed (10 months)	4,127
Share of tax cut spent	60%
Dollar amount of tax cut spent	2,476
Share spent on taxable items	50%
Dollar amount spent on taxable items	1,238
Sales tax rate	6%
Sales tax revenues generated	74

These impacts represent the “first round” effects from an extension of the payroll tax cut. As the additional spending works its way through the state economy and is spent again, the final impact on total output would be greater than the original \$2.5 billion of additional spending. However, it is likely that the impact from those next rounds of spending would be minor compared to the first round. Employment would also increase in response to the additional spending, but the potential impact on the labor market is less certain, and any positive impact might be temporary.

¹ U.S. Social Security Administration, Office of Retirement and Disability Policy, Annual Statistical Supplement, 2010; <http://www.ssa.gov/policy/docs/statcomps/supplement/2010/4b.html#table4.b10>.

² See Shapiro and Slemrod, “Did the 2008 Tax Rebates Stimulate Spending?”, NBER Working Paper No. 14753 and Parker, Souleles, Johnson and McClelland, “Consumer Spending and the Economic Stimulus Payments of 2008”, NBER Working Paper No. 16684.

³ Across all consumer expenditures, the average figure is closer to 35 percent. However, research suggests that marginal or additional income would be more weighted towards taxable items such as durable goods purchases compared to the “average” or typical consumer purchase. For expenditure data, see the National Income and Product Accounts Table 2.5.5: <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1>.

This analysis does not include the economic impacts attributable to the various methods used to fund the tax cut extension, such as increased federal borrowing, revenue raising measures, expenditure reductions or some combination thereof. Currently, it is not clear which method Congress will use to fund the proposed extension. However, regardless of the funding method used, the proposed payroll tax cut extension will have implications for the Pennsylvania economy in the near term. The latest economic forecast used for revenue projection purposes assumes that the payroll tax cut will be extended through 2012.