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Budget Model

Payroll Tax Holiday: Budgetary, Economic and Distributional Effects

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Summary: We estimate that a one-year "payroll tax holiday" would cost the federal government between $141 and $151 billion over the standard budget window and increase GDP by 0.3 percent in 2020, with effects eventually turning slightly negative over time with higher deficits.

On Tuesday August 20th, President Donald Trump made comments suggesting that the White House is exploring proposals to cut payroll taxes. These remarks follow a report from the Washington Post that the Administration is considering a payroll tax holiday to address a perceived economic slowdown. On Wednesday August 21st, the President stated that he is "not looking at a tax cut now." That said, a payroll tax holiday has historical precedent: in both 2011 and 2012, the OASDI payroll tax rate faced by employees was reduced from 6.2 percent to 4.2 percent.

To explore how this policy would affect today's economy, PWBM modeled a 2 percentage point employee-side payroll tax cut starting January 1st, 2020 and ending December 31st, 2020. For calendar year 2020, employees would pay 4.2 percent rather than 6.2 percent. Following historical precedent, we assume that revenues from the general fund would be redirected to the Social Security Trust Fund to cover the temporary shortfall and that future Social Security benefits are unaffected by the policy change.

Budgetary Effects

Table 1 reports PWBM's projections of how a payroll tax holiday would impact the budget. On a conventional basis, PWBM estimates the policy would cost $151 billion in calendar year 2020. This loss would be spread across fiscal years 2020 and 2021, and the policy would not lose revenue beyond January 1st, 2022. After accounting for macroeconomic feedback, the revenue loss would be slightly less, at $141 billion over the budget window.

Table 1: Effects of a 2 Percentage Point Payroll Tax Holiday on Federal Revenues (billions of $)

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	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2020-29
Conventional	-117.1	-33.7	0	0	0	0	0	0	0	0	-150.8
Dynamic	-113.9	-33.1	0.8	0.7	0.7	0.7	0.7	0.7	0.8	0.7	-141.1

Economic Effects

Table 2 shows PWBM's projections of how key economic variables would change. We estimate that this policy would increase GDP in 2020 by 0.3 percent. This positive boost is temporary. The following year, GDP would fall to a level slightly above where it would be under current policy and long run output would be slightly lower due to a larger amount of debt and reduction in future labor supply.

Table 2: Effects of a 2 Percentage Point Payroll Tax Holiday on Key Macroeconomic Variables

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Year	GDP	Capital services	Labor income	Hours worked
2020	0.29%	0.04%	0.29%	0.65%
2030	0.00%	0.02%	0.00%	-0.02%
2040	-0.02%	-0.03%	-0.02%	-0.01%
2050	-0.04%	-0.11%	-0.04%	-0.02%

The temporary increase in GDP comes primarily from increases in labor input. In response to a lower marginal tax rate on labor earnings, overall labor supply rises. Some of this effect would be at the intensive margin (e.g., current workers choosing to work overtime) and some would be at the extensive margin (e.g., new workers entering the labor force).

Firms and workers face various frictions with regard to labor supply and labor demand. On one hand, some employees do not have the ability to easily change the number of hours they work per week. On the other hand, many types of hourly workers can increase their hours worked, and other workers can enter and exit the job market.

Distributional Effects

Because the tax base is limited to earnings below the maximum set by law ($132,900 in 2019), OASDI taxes are modestly regressive under current law. This limit means that, generally speaking, payroll tax cuts are progressive tax changes.

Table 3 presents PWBM's estimates of the distributional consequences of a 2 percentage point payroll tax cut in 2020. Average tax liabilities would fall for households in every income group. The increase in after-tax incomes would be largest for the bottom 90 percent and smallest for the richest Americans. Compared to the rest of the income distribution, fewer households in the poorest 20 percent would receive a tax cut because a smaller share of people in this group have wages or self-employment earnings and thus pay no OASDI taxes to begin with.

Table 3: Distributional Effects of a 2 Percentage Point Payroll Tax Holiday, 2020

	Average tax change	Tax units with tax cut		Average percent change in after-tax income	Share of federal taxes paid		Share of tax change
		Share with tax cut	Average tax change		Current law	Policy	
Bottom quintile	-$50	0.296	-$165	1.5%	-0.3%	-0.4%	1.6%
Second quintile	-$410	0.905	-$455	1.7%	0.5%	-0.1%	10.0%
Middle quintile	-$785	0.887	-$885	1.7%	8.1%	7.4%	18.7%
Fourth quintile	-$1,280	0.853	-$1,500	1.6%	16.9%	16.3%	26.3%
80-90%	-$2,230	0.917	-$2,435	1.7%	14.1%	13.8%	19.0%
90-95%	-$2,795	0.939	-$2,980	1.5%	11.0%	11.0%	11.3%
95-99%	-$3,215	0.941	-$3,415	1.1%	17.7%	18.2%	10.3%
99-99.9%	-$3,245	0.943	-$3,440	0.4%	15.0%	15.8%	2.3%
Top 0.1%	-$2,905	0.918	-$3,165	0.0%	16.7%	17.8%	0.2%

Notes: Includes nondependent income tax filers and non-filers. Income is defined as AGI plus: above-the-line deductions, nontaxable interest income, nontaxable Social Security benefits, nontaxable pensions and annuities, employer-side payroll taxes and corporate tax liability. Seventy-five percent of the corporate tax burden is assumed to fall on corporate equity; the rest is assumed to fall on wages.