



Policy Memorandum

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COMPLEMENTING RECOVERY POLICIES WITH A JOBS CREATION TAX CREDIT

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The U.S. economy is currently mired in the most severe recession since the Great Depression. There are 15.1 million people unemployed, and the economy has lost 8.0 million jobs since the recession began nearly two years ago.

Policy initiatives already enacted, including the American Recovery and Reinvestment Act of 2009, have lessened the severity of the crisis and have likely prevented a worse economic collapse. However, we now know that the downturn that started in 2008 is much deeper than was anticipated. In particular, the magnitude of the gross domestic product (GDP) decline and the resulting job loss were greater than anticipated by both private and government forecasters.

While many believe that the overall economy has stopped shrinking in the third quarter (July through September), it is almost certain that employment will continue to erode for many more months and unemployment will remain unacceptably high for years to come. Projections suggest that the unemployment rate will remain at or near 10% through the end of 2010. Even if hiring does pick up, it would take at least 29 months of job creation above 500,000 jobs per month to regain pre-recession employment levels and to keep up with the growth of the labor force.

In short, without further action, there will be serious a jobs deficit for years to come.

This means that further steps are needed to directly address job creation. Traditional “stimulus” policy aims to spur the economy by boosting economic demand—either through direct government procurement, tax cuts/direct assistance to spur consumer demand, or incentives for firms to invest. The additional demand will boost output and job creation as firms hire labor to increase production. While these efforts are essential, they do not necessarily change the incremental cost to firms who may be thinking about hiring new employees. A comprehensive approach would also include a mechanism to more directly encourage hiring.

A tax credit for new job creation deployed over the next two years could complement these more traditional policies. According to our estimates, a tax credit for firms equal to 15% of expanded payroll costs would lead them to hire an additional 2.8 million employees next year. The cost of this program would be relatively low. Net revenue losses to the

federal government would total an estimated \$28 billion in the first year, but half of these costs would likely be recouped in lower spending on unemployment insurance, Medicaid spending, and other safety net programs.

An effective and comprehensive approach to job creation would include policies to both increase the demand for products as well as change employer incentives to hire new workers.

Job Creation Tax Credit

To encourage employers to expand their workforce, a tax credit for businesses, non-profits, and even governments that hire new employees over the next two years. This proposal adheres to several principles in the design. Such a credit would have to be:

1. *Wide-ranging.* The tax credit should be designed to stimulate a wide range of jobs across economic sectors and across all kinds of firms, regardless of size or current profitability.
2. *Temporary.* It should be of limited duration to encourage job creation when the labor market is weakest and to limit the cost to the treasury.
3. *Large.* It should be large enough so that it will lead firms to hire new employees, and cause a significant number of jobs to be created economy-wide.
4. *Efficient.* The tax credit should target new job creation as much as possible and not simply be a handout to businesses.

In line with these principles, we suggest a broad-based refundable tax credit for employers that expands their workforce in 2010 and 2011. In the first year the credit would be equal to 15% of the net increase in that portion of a firm's payroll subject to Social Security taxes. In the second year the credit would drop to 10%. This would encourage firms to hire sooner rather than later, and would provide a significant incentive for expanded employment. Furthermore, this is a time period when new jobs are clearly needed.

To ensure that the credit is most effective at stimulating new hiring and to ease implementation, the credit would be calculated as a percentage of the increment to firms' Social Security payroll tax expenses over a base amount. We suggest using firm's payrolls in the four quarters prior to enactment (adjusted for inflation), and calculating the tax credit based on the incremental increase in the expenses for payroll taxes paid. This could be implemented by providing the tax credit as part of the employers' quarterly filing of their IRS Form 941, which they use to report Social Security and Medicare payroll taxes. Adding a few lines to the Form 941 would allow a wage credit to be implemented relatively simply. This credit would be refundable so even firms that are not profitable would benefit. It would also be provided quarterly so it would help firms' cash flow immediately after hiring.

The credit should also be broad-based. The wage credit should be extended to all private firms, non-profit organizations, and state and local governments.

By applying the credit based on total Social Security payroll taxes, the credit would also reward expansion of work hours as well as employment. The credit should also be based on that portion of wages that is subject to Social Security payroll taxes to ensure that the credit does not apply to wages increases for very high wage earners.

Impact

The Job Creation Tax Credit as outlined above would have significant impact on job creation. Using estimates of how wage costs influence employer hiring, we find that the credit would lead to the creation of 2.8 million new jobs in the first year, and slightly less in the following year as the tax credit is reduced.

The cost of the program is relatively modest. The initial revenue loss from the credit would immediately be limited due to offsetting increases in revenue from corporate tax receipts and individual tax payments. We estimate the net revenue cost to be \$28 billion in the first year, and \$26 billion in the second year in the most likely scenario. However, the total cost to the government would be significantly less since greater employment also means less spending on social safety net programs like unemployment insurance, health care, and nutrition assistance. We estimate that these savings would total \$15 billion in the first year and \$12 billion in the second.

All told, the Job Creation Tax Credit would be a cost-effective way to create jobs. Average annual wages in the United States subject to Social Security taxes are about \$43,000 per full-time employee, so a 15% credit, on average, provides employers with about \$6,500 per additional worker. However, even in a down economy many firms find the need to expand their workforce, even without a tax credit. As such, much of the credit will inevitably go to firms that would have expanded anyway. Factoring in the revenue loss from jobs that would have been created anyway, the cost would be about \$4,700 per net new job created in the first year. This compares favorably to other means of generating jobs and is certainly much more favorable than other business tax breaks, which typically have very low “bang-for-the-buck” in creating jobs.

Given the substantial costs of unemployment to individuals and the economy as a whole, a tax credit targeted at new job creation can be an effective part of a broad-based strategy to restore economic growth and create millions of new jobs. And these jobs are needed—the Congressional Budget Office has forecast that the pre-recession unemployment rate of 4.7% will only be reached again in 2014. This is simply unacceptable; policy makers must make robust job growth a top priority.