Policy Memorandum

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JOBS AND WAGES TAX CUT SHOULD BE PART OF A NEW JOBS PACKAGE

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The Obama administration has proposed a "Small Business Jobs and Wages Tax Cut" (JWTC) as a means of spurring job growth over the next year. The JWTC, if passed as proposed, could create roughly 1 million new jobs over the next year.

What is the JWTC?

The JWTC provides a $5,000 tax credit to be applied against a firm's payroll taxes for each (net) new employee they hire in 2010. Beyond this $5,000 per capita credit, the JWTC will also pay the full employer-side increase in Social Security taxes for net new additions to payroll.

So for a small business that adds three workers to its payroll, each earning $50,000 per year, the JWTC would credit that business $24,300 dollars ($5,000 + 6.2% of $50,000 for each of the three employees).

Can it be gamed?

Not very easily. For one, the credit is only on net new additions to payroll. If the small business above hired three new workers but fired three existing ones, it would be able to claim zero credits.

Further, because the credit is based on a firm's payroll taxes, if a business fired three workers making $50,000 per year and replaced them with six workers making $25,000 per year, they would not be able to claim a credit.

Also, because the credit is based only on that portion of payroll subject to Social Security taxes, it applies only to wages below the Social Security wage base of $106,800. So, large pay increases given to highly paid managers making more than this will receive zero credits.

Lastly, the credit will be capped at 25% of the increase in a firm's Social Security payroll wage base. This would reduce incentives for expanding employers to replace full-time work with part-time work to collect the $5,000 per capita credit on each new hire while not expanding hours in the same proportion that they are expanding head-count.

Won't it just reward many employers for doing what they were already planning to do?

The JWTC will indeed provide credits to employers who had already planned to add to payrolls. However, even in these cases a significant portion of the JWTC cost will be recouped through higher tax collections on business income. And even the JWTC that goes to those employers that would have hired new employees in the absence of the JWTC introduces extra purchasing power into the economy.In an economy where private-sector purchasing power is severely lagging, this is not a bad outcome.

Further, while some employers will be rewarded for doing what they had already planned to do, the JWTC will also induce many employers to undertake hiring that they would not have done without the credit.

Lastly, it needs to be remembered that all stimulus proposals have significant "leakages." Personal tax cuts, for example, can be saved or spent on imports, neither of which boosts the U.S. economy. What matters is the *net* effectiveness of a given proposal, and on this score the JWTC performs very well.

What would be the economic impact and cost of the JWTC?

Based on experience modeling the impact of job creation tax credits (JCTC) used in an earlier EPI report (Bartik and Bishop (2009)) and on the Obama administration's cost estimate of $33 billion, we estimate that this credit would create roughly 1.1 million jobs in the coming year. The proposed JWTC is close enough in structure to the JCTC proposed by Bartik and Bishop that we can roughly estimate this jobs effect simply by dividing the aggregate cost of each measure. The only reason that this would yield a misleading estimate of the jobs impact is if the ratio of induced hires to already-planned hires changed due to the $500,000 per firm cap that is part of the JWTC and not part of the JCTC. We see no particular reason why this cap would bias this ratio one way or the other.

This gain of 1.1 million jobs corresponds to about $30,000 per full-time-equivalent job created, a very high bang-for-buck when compared to other stimulus proposals. Further, this cost does not factor in the additional tax revenue and reduced spending on safety net programs that could result as people move out of unemployment and into work. These "dynamic effects" could drive the net fiscal costs of the JWTC to well under $10,000 per job created.

Doesn't the minimum wage research literature tell us the JWTC won't work?

No. The empirical research on the responsiveness of total employment to cuts in the marginal cost of labor clearly identifies that a 10% reduction in labor costs yields a 1.5-3% increase in labor demand. However, the empirical research on the responsiveness of low-wage employment to a 10% (or more) increase in the minimum wage finds zero effect in most cases. This does not seem like a particular puzzle—economic parameters measuring labor market responsiveness often vary across different sub-populations of workers, and there are plenty of reasons to think that the low-wage labor market behaves differently than the aggregate labor market. Believing that the JWTC can increase employment while minimum wage increases will have no appreciable effect on employment does not require intellectual inconsistency, it just requires believing the consensus empirical results in the literature.

Isn't the current problem in the U.S. economy not enough demand, not too-expensive labor?

The most pressing problem facing the U.S. economy right now is indeed insufficient demand. However, the JWTC does address this problem—deficit-financed tax cuts are, by definition, economic stimulus that add purchasing power to the economy.

The JWTC has the added virtue of also biasing new production toward using more labor and less of other inputs. This maximizes the jobs bang-for-buck of a given increase in output. Combining the JWTC along with other ambitious measures to increase demand throughout the economy attacks the jobs crisis from two sides.

If the JWTC has no effect at all on changing the incentives of employers and only its stimulative effect aids recovery, it still scores pretty well on "bang-for-buck" assessments of various economic stimulus proposals. Essentially, the JWTC can be modeled as a payroll tax cut. Mark Zandi of Moody's Economy.com has rated a number of economic stimulus proposals based on their effectiveness of spurring additional economic output per each dollar increase in the deficit, and a payroll tax cut scores well ahead of across-the-board tax cuts and is two to four times more effective than any other tax benefit aimed at businesses. In short, it's hard to miss the mark completely with the JWTC. Even if it fails to change hiring behavior directly, it would still rank as one of the more effective recession fighters included in an overall jobs package.

How does the JWTC compare to some Congressional proposals for employment tax credits?

Besides the JWTC, there are two other temporary tax credits for employment creation under consideration by the Senate. One proposal has been put forward by Senator Bob Casey (D-Penn.); another has been jointly introduced by Senators Charles Schumer (D-NY) and Orrin Hatch (R-Utah).

The Casey proposal is for a tax credit of 20% of payroll costs for small firms (defined as those with less than 100 workers) and 15% of payroll costs for large firms (defined as those with over 100 workers). It limits the credit per firm that may be claimed to $350,000. The Schumer/Hatch proposal is for a wage credit equal to 6.2% of payroll costs if a firm hires a worker who has been unemployed for at least 60 days.

The Casey proposal is close in design to the Obama administration's JWTC and should prove an effective job-creator if passed. Both proposals offer large credits that cap the benefits that very large employers can claim, and proposals are tilted (using different mechanisms) toward employing lower- and middle-wage workers. The most important issues regarding both proposals are that the credit they provide is big enough to change employer behavior and that they spend enough money overall to actually create a significant number of jobs in the coming year.

The Schumer/Hatch proposal, conversely, is both too small a credit and is too restrictive in its eligibility requirements to move the dial enough on employment growth. While the impulse to do something to particularly address the plight of longer-term unemployed workers is admirable, given the extent of the jobs crisis there seems little reason to deny the credit to firms who can only find workers to hire who have been unemployed less than 60 days, or even those who are hiring already-employed workers away from other firms. Even hiring the already-employed increases the number of vacancies in the economy that the pool of jobless can move into and should, therefore, be encouraged. Further, the Schumer/Hatch proposal would only grant the credit if employees worked for 30 hours a week or more. This seems like a mistake—in the early stages of recovery, any employment growth, even part-time employment, is a positive good.

References

Bartik, Tim, and John Bishop. 2009. *The Jobs Creation Tax Credit: Dismal Employment Projections Call for a Quick, Efficient, and Effective Response.* Economic Policy Institute Briefing Paper #248. Washington, D.C.: EPI.