Payroll tax, federal

Maureen Anne Griffin
Congressional Budget Office

A group of taxes based on the earnings of employees and self-employed persons.

As a revenue source, federal payroll tax revenues have grown substantially in the past 60 years. As a share of total receipts, payroll taxes increased from 10 percent in 1937 to 34 percent in 1997. Over the same period, payroll taxes grew from 1 percent to 7 percent of gross domestic product.

Components of federal payroll taxes

Federal payroll taxes, or social insurance contributions, consist of tax revenues from Social Security, Medicare hospital insurance, unemployment insurance, railroad retirement, and other retirements. Social Security comprises the lion's share of federal payroll taxes—73 percent of the $539 billion collected in 1993. Medicare, the second largest component, comprises 20 percent of payroll tax revenues. The remaining revenue is divided between unemployment insurance (5%), railroad retirement (less than 1%), and other retirements (1%).

Social Security

Social Security (OASDI, or Old Age, Survivors, and Disability Insurance) began in the late 1930s as a mandatory old-age insurance program for most employees in the private sector. Over time, the program was expanded to include disability insurance and mandatory coverage for almost all workers.

The Social Security Act of 1935 provided monthly benefits to retired workers covered by Social Security. In 1939, benefits were extended to the dependents and survivors of covered workers. The program was further expanded to provide disability insurance to covered workers and their dependents in 1956 and 1958, respectively.

Even in its infancy, coverage under Social Security was broad. All workers in commerce and industry—except railroad workers, who had their own retirement plan—were originally covered under Social Security. Beginning in the 1950s, coverage was expanded to include most workers in the private sector not originally covered. Participation was mandatory for some, such as farm and domestic workers, active military personnel, and self-employed persons, and elective for others, such as nonprofit workers, state and local government workers, and employees of religious bodies. Additional legislation in the mid-1980s expanded coverage to federal workers hired after 1983 and mandated coverage for employees of nonprofit organizations. In 1994, about 95 percent of all jobs in the United States were covered by Social Security. Workers excluded from coverage fall into four major categories: federal civilian employees hired before 1984, railroad workers, certain state and local government workers covered under a retirement system, and workers whose earnings do not meet minimum earnings requirements.

Benefits earned by covered workers are financed primarily by a payroll tax on a worker's wages. (Two other sources of income to finance benefits are income tax revenues from the taxation of some Social Security benefits and interest income earned on the Social Security Trust Fund reserves.) Both the employee and the employer pay taxes based on the worker's earnings up to a maximum amount or taxable maximum earnings base. In 1937, both employee and employer each paid a 1 percent tax, levied on all covered earnings up to $3,000. This captured the full earnings of about 97 percent of all covered workers. Since then, both the tax rate and the maximum taxable earnings base have been increased by myriad legislative measures. The most recent increase in the OASDI tax rate occurred in 1990, when the rate was increased from 6.06 percent to 6.2 percent. The tax rate applicable to self-employed persons has varied over the years; since 1990, self-employed persons have been subject to a tax rate of 12.4 percent, which is equal to the combined employee and employer tax rates. The taxable maximum was increased by a series of ad hoc legislative changes until 1975, when Congress tied the maximum earnings base to changes in the national average wage. Since then, the taxable maximum earnings base has been automatically indexed each year. In 1996, the taxable maximum earnings base was $62,700, which is expected to capture the full earnings of around 95 percent of the work force.

Social Security tax revenues are allocated between the Old Age and Survivors Insurance (OASI) Trust Fund and the Disability Insurance (DI) Trust Fund. During the 1990s, the DI trust fund was facing exhaustion, so Congress changed the allocation of funds between the OASI and DI trust funds in a series of steps. The final scheduled change in this allocation, 5.3 percent to OASI and 0.9 percent to DI, is scheduled to take effect in 2000.

Medicare hospital insurance

The Social Security Act was amended in 1965 to include Medicare hospital insurance (HI). This program, which is financed primarily through payroll taxes, provides hospitalization benefits to eligible persons age 65 or older. Generally, eligible persons have paid HI taxes based on their covered earnings.

For many years, the pool of workers paying HI taxes and the taxable maximum earnings base were identical to those under Social Security. In the mid-1980s, however, the HI pool was expanded to include all federal workers and all state and local workers hired after March 31, 1986. In 1991, the HI taxable maximum earnings base was raised from $53,400 to $125,000, and in 1994 it was eliminated entirely, thereby decoupling it from the Social Security base, and making all covered earnings subject to the tax.

The HI tax rate is 1.45 percent on all covered earnings. Both the employee and the employer pay this tax rate, and self-employed persons pay the combined tax rate. While the original tax rate was 0.35 percent in 1966 and has increased steadily over the past three decades, no further increases are currently scheduled.

All revenue generated from the HI payroll tax is deposited in the Hospital Insurance Trust Fund. Revenues in that trust fund are used to finance inpatient hospital, skilled nursing facility, home health, and other institutional services.

Unemployment insurance

Unemployment insurance (UI) payroll taxes began in the 1930s; the taxes are used to finance unemployment benefits for workers involuntarily unemployed.

Basically, there are two parts to the UI payroll tax: the Federal Unemployment Tax Act (FUTA) tax and the state tax. FUTA taxes finance the administrative expenses of the program, the federal account for state loans, and one-half the expense of extended benefits. State taxes, which are deposited in the U.S. Treasury, finance regular UI benefits and half the expense of extended benefits.

The FUTA program is designed to induce state participation by granting a credit against the federal tax if the state program conforms to federal standards. FUTA generally determines which workers are covered by UI. Originally, coverage was limited to industrial and commercial workers in the private sector. Currently, the vast majority of workers, with the exception of self-employed persons, are eligible for UI benefits. In addition, FUTA mandates a taxable maximum earnings base. Each state determines the amount and duration of benefits, the tax rate, and eligibility requirements.

FUTA currently imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in states with programs approved by the federal government and with no delinquent federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net federal tax rate 0.8 percent. Originally, the FUTA tax applied to total annual wages. In 1939, however, a $3,000 taxable wage base was established that exceeded the annual wages of 98 percent of the workers subject to the tax. The taxable wage base was increased three times: to $4,200 in 1972, to $6,000 in 1978, and to $7,000 in 1983.

States must impose a payroll tax on employers for at least the first $7,000 paid annually to each employee to be eligible for the 5.4 percentage point FUTA credit. In 1996, 40 states had taxable wage bases greater than $7,000; Hawaii has the highest base, at $25,800. All state laws have experience ratings that have the effect of varying individual employers' tax rates from the standard rate of 5.4 percent based on their previous unemployment experience. The estimated national average of state tax rates was 2.2 percent in 1995, with rates ranging from 0.6 percent in South Dakota and North Carolina to 4.9 percent in Pennsylvania.

Railroad retirement

Federal involvement in providing and financing railroad retirement began in the mid-1930s, when declines in the railroad industry imposed tremendous financial hardships on the railroads. The program has been revamped several times; the latest overhaul was in 1974, when the current system was established. The retirement system has two tiers that are financed by federal payroll taxes. (The other components of the retirement system provide supplemental benefits to certain workers. The programs are financed through general fund transfers and a cents-per-hour tax paid by employers.)

Both tiers of the program are financed by a payroll tax on the worker's wages. The tier 1 tax rate is equivalent to the combined Social Security and Medicare HI tax rate. Under tier 1, both employee and employer pay taxes on covered wages up to the applicable maximum taxable earnings base for Social Security ($62,700 in 1996) and all covered wages for HI. Under tier 2, the wage base is equal to what the Social Security tax base would have been without the ad hoc increases in the taxable wage base provided by the Social Security amendments of 1977. In 1996, the tier 2 taxable wage base was $46,500. Unlike tier 1 and Social Security, where both the employer and employee tax rates are 7.65 percent, tier 2 employer's contributions are much greater. The tier 2 employer and employee tax rates are 16.10 percent and 4.90 percent, respectively.

Other retirements

Basically, revenues classified as "other retirements" in the federal budget are the retirement contributions of federal government workers. [Employer and employee payroll taxes for District of Columbia government employees covered under the Civil Service Retirement System (CSRS) are also included as other retirement revenues in the federal budget.] Federal government workers are covered under one of two programs. For decades, all workers were covered under the CSRS. Under this program, most employees pay a 7 percent tax on all wages. (A higher tax rate is levied on workers in special groups, such as law enforcement officers and congressional staff.) In 1984, a new retirement program for federal workers, the Federal Employees' Retirement System (FERS), was introduced. FERS is mandatory for new workers and elective for CSRS participants. FERS replaced the defined benefit program under CSRS with a program integrated with Social Security. FERS uses Social Security as a base, adds a supplemental benefit financed by a 0.8 percent tax on taxable wages, and then adds a deferred compensation plan. The supplemental tax of 0.8 percent is a payroll tax. (Under both programs, the federal government also makes an employer contribution based on the workers' wages; this, however, is not included in the revenue totals.)

Incidence of federal payroll taxes

Compared with the other major federal tax source—individual income taxes—payroll taxes have low administration and compliance costs, but this is at the expense of progressivity. Payroll taxes are less progressive than individual income taxes because all payroll taxes tax only earned income, and most include a maximum taxable earnings base. Currently, the effective or average federal payroll taxes are progressive only in the lowest income quintile, virtually flat across the three middle income quintiles, and regressive in the top quintile (U.S. Congress, Congressional Budget Office 1994). In an effort to increase the progressivity of Social Security, the largest payroll tax, the earned income tax credit (EITC) was introduced in 1975 to lighten the burden on working people below certain incomes. Since then, the EITC has been expanded several times, including the two most recent Omnibus Budget Reconciliation Acts in 1990 and 1993.

Additional readings

Musgrave, Richard A., and Peggy B. Musgrave. *Public Finance in Theory and Practice.* 4th ed. New York: McGraw-Hill, 1984.

Pechman, Joseph A. *Federal Tax Policy*. 5th ed. Washington, D.C.: The Brookings Institution, 1987.

Rosen, Harvey S. *Public Finance*. Homewood, Ill.: Richard D. Irwin, 1985.

U.S. Congress, Congressional Budget Office. *The Economic and Budget Outlook: Fiscal Years 1995–1999.* 103rd Cong., 2d sess., 1994.

U.S. Congress, House of Representatives, Committee on Ways and Means. *Overview of the Federal Tax System.* 103rd Cong., 1st sess., 1993.

U.S. Congress, House of Representatives, Committee on Ways and Means. *Overview of Entitlement Programs: 1996 Green Book.* 104th Cong., 2d sess., 1996.

Cross references: earned income credit; fairness in taxation; Medicare trust fund; Social Security benefits, federal taxation; Social Security Trust Fund.