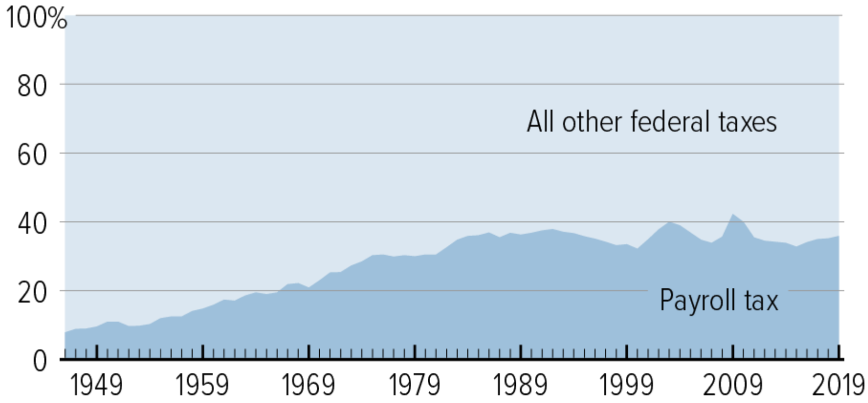
Policy Basics

Federal Payroll Taxes

The federal government levies payroll taxes on wages and self-employment income and uses the revenue to fund Social Security, Medicare, and other social insurance programs. Payroll taxes have become an increasingly important part of the federal budget over time, as the chart below shows. In fiscal year 2019, federal payroll taxes generated $1.24 trillion, which amounts to 5.9 percent of the nation's gross domestic product (GDP), or 35.9 percent of all federal revenues.

Payroll Taxes as a Share of Federal Revenues



Note: "Other federal taxes" include individual and corporate income taxes, estate and gift taxes, excise taxes, profits on assets held by the Federal Reserve, customs duties and fees, and other smaller revenue sources.

Source: Office of Management and Budget

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Payroll Taxes Fund Social Security and Medicare

The two main federal payroll taxes levied on wages are known as **Federal Insurance Contributions Act (FICA) taxes**. Employees and employers both pay FICA taxes: employees usually have them withheld from their paychecks, while employers pay them in addition to any other taxes they owe. However, most economists agree that employees bear the true cost of employer payroll taxes in the form of lower wages. The two FICA taxes are:

- **Social Security tax**, also known as the Old-Age, Survivors, and Disability Insurance (OASDI) tax. It is levied at a rate of 12.4 percent (split evenly between employees and employers) up to a maximum amount of an employee's wages ($137,700 in calendar year 2020). This wage cap is adjusted annually to take account of increases in average wages. The revenues go toward funding Social Security, which pays benefits to retirees, persons with disabilities, and survivors of deceased workers.
- **Medicare tax,** also known as the Medicare Hospital Insurance (HI) tax. It is levied at a rate of 2.9 percent of wages (split evenly between employees and employers); unlike the Social Security tax, there is no wage cap. Married filers' earnings over $250,000 (and singles' earnings over $200,000) are taxed at an additional 0.9 percent, for a total of 3.8 percent on this income. Revenues from the Medicare tax support the hospital insurance portion of Medicare. (There is a 3.8 percent tax on net investment income for high-income taxpayers as well, but it isn't withheld through the payroll tax or reserved for the Medicare Hospital Insurance trust fund.)

People who work for themselves pay a **self-employment tax** — the Self Employment Contributions Act (SECA) tax — to fund Social Security and Medicare. These taxes are equivalent to FICA taxes; the same total rates and caps apply.

A third federal payroll tax is the **Federal Unemployment Tax Act (FUTA) tax.** Employers pay an effective rate of 0.6 percent on the first $7,000 of a worker's wages, up to $42 per worker per year. The revenues mainly go toward financing the administration of state unemployment insurance programs. Each state collects an additional unemployment payroll tax to further finance unemployment benefits. (For more, see Introduction to Unemployment Insurance.)

Payroll Taxes Have Larger Impact on Lower-Income People

Payroll taxes are regressive: low- and moderate-income taxpayers pay more of their incomes in payroll tax than do high-income people, on average. The bottom fifth of households will pay an average of 6.9 percent of their incomes in payroll tax in 2020, according to Tax Policy Center estimates, while the top fifth will pay 5.9 percent and the top 1 percent of households will pay just 2.3 percent. These figures include the employer and employee shares of the payroll tax.

However, if one looks at the overall impact of Social Security, Medicare, and unemployment insurance — the benefits they provide as well as the taxes they collect — these programs are progressive. For instance, Social Security benefits represent a higher proportion of a worker's previous earnings for workers at lower earnings levels; and while all Medicare beneficiaries are eligible for the same services, high-income beneficiaries pay more in Medicare taxes and premiums.

Updated April 17, 2020