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Taxable Payroll and Payroll Tax Rates

By Peter R. Orszag

In 1966, when payroll taxes for Medicare's Hospital Insurance (HI) program began to be collected, the taxable payroll base was identical to that under the Old-Age, Survivors, and Disability Insurance (OASDI) program and the tax rate was less than a tenth of OASDI's. While the payroll tax rates for both programs have increased since 1966, the HI rate has risen faster. The HI rate is now almost one-quarter of the OASDI rate (see dotted line on figure).

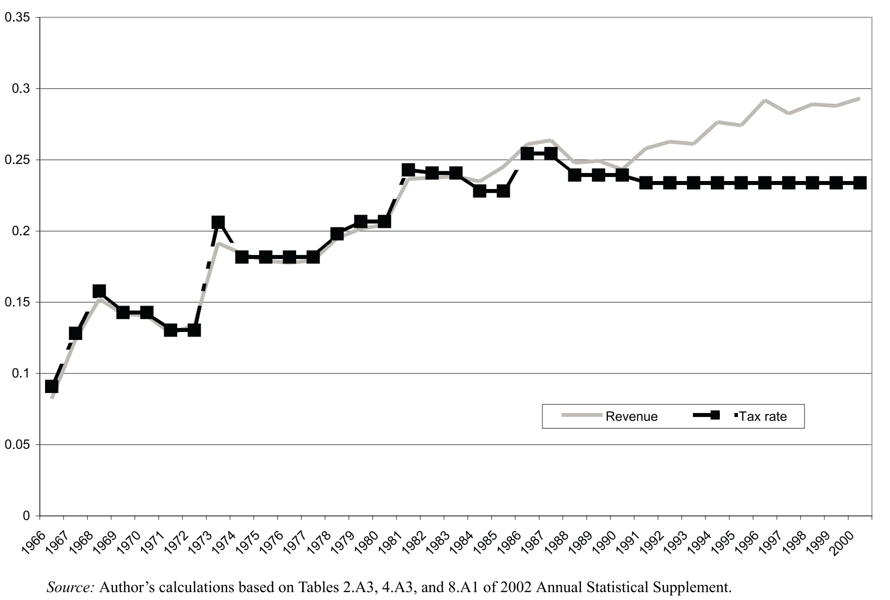
In addition, the HI tax base has increased relative to the OASDI base since 1990. In 1990, both OASDI and HI taxes applied only to the first $51,300 of earnings (an amount indexed to the rate of wage growth). Legislation in 1990 roughly doubled the amount of earnings subject to HI tax; the Omnibus Budget Reconciliation Act of 1993 removed the cap altogether.

The result is shown in the graph on the right: The solid line shows the payroll tax revenue collected under HI as a share of the payroll tax revenue collected under OASDI. Until 1990, the revenue share tracks the relative tax rates closely.

Since 1990, the relative payroll tax rates have remained constant, but HI revenue has risen relative to OASDI revenue. Indeed, HI revenue continued to increase on a relative basis even after 1993 (rather than stabilizing at a new, higher level) because the share of aggregate earnings above the OASDI payroll cap has risen since the early 1990s. In 1990, earnings above the maximum taxable earnings level under OASDI amounted to 12.8 percent of aggregate earnings. In 2001, they amounted to 17.0 percent. Unlike OASDI, HI revenue reflects these earnings. (It is of course unclear whether the economic forces that generated more rapid wage growth above the cap than below it in the 1990s will persist in the future.)

Removing the current $87,000 cap on taxable payroll under OASDI would raise more than $1 trillion in revenue over the next 10 years and close a substantial share of the long-term OASDI deficit. Such a step would, however, undoubtedly raise questions about the linkages between payroll taxes and benefits within OASDI, and significantly raise average and marginal tax rates on wages for the approximately 6 percent of workers with earnings above the current maximum taxable level.

HI Revenue and Tax Rates as a Percentage of OASDI



Source: Author's calculations based on Tables 2.A3, 4.A3, and 8.A1 of 2002 Annual Statistical Supplement.