Key Elements of the U.S. Tax System

Q. What are the major federal payroll taxes, and how much money do they raise?

A. Payroll taxes are levied to finance Social Security, the hospital insurance portion (Part A) of Medicare, and the federal unemployment insurance program. Revenue totaled just over $1.1 trillion, or about 6.1 percent of gross domestic product, in fiscal year 2017.

SOCIAL SECURITY

Social Security, or more formally, Old-Age, Survivors, and Disability Insurance (OASDI), provides benefits to elderly and disabled workers, their spouses, and surviving spouses or dependents. It is one of the largest items in the federal budget, with outlays of $939 billion in 2017.

Benefits are mainly financed by a payroll tax on cash wages, up to an annual maximum indexed to average wage growth (table 1). In 2018, maximum taxable wages are $128,400. Employers and employees each contribute 6.2 percent of the workers' wages for a combined 12.4 percent—usually 10.6 percent for the OASI trust fund (retirement and survivors) and 1.8 percent for the DI trust fund (disability).

The Bipartisan Budget Act of 2015 temporarily reallocated a portion of the OASI tax to the DI trust fund for 2016–18 to shore up the DI trust fund, which faced insolvency. For those years, the combined employer and employee rates are 10.03 percent for OASI and 2.37 percent for DI. Most economists believe that the employer portion of the tax, just like the employee portion, is borne by employees in the form of lower compensation.

TABLE 1

Major Federal Payroll Tax Rates and Bases

2018

Source	Wage Base	Employer Rate	Employee Rate	Total Rate
Old Age and Survivors Insurance (OASI)	$128,400	5.30%	5.30%	10.60%
Disability Insurance (DI)	$128,400	0.90%	0.90%	1.80%
Hospital Insurance (HI)	No limit	1.45%	1.45%	2.90%
Federal Unemployment Insurance (UI)	$7,000	0.60%	0.00%	0.60%

Source: Social Security Administration, "2018 Social Security Changes Fact Sheet," 2018; Department of Labor, "Unemployment Insurance Tax Topic," 2018.

Notes: Wage bases for OASI and DI are adjusted each year to account for wage growth. The Bipartisan Budget Act of 2015 reallocated a portion of the OASI tax to DI in 2016-2018. The rates in those years are OASI: 5.015 (employer and employee), DI: 1.185 (employer and employee).

Key Elements of the U.S. Tax System

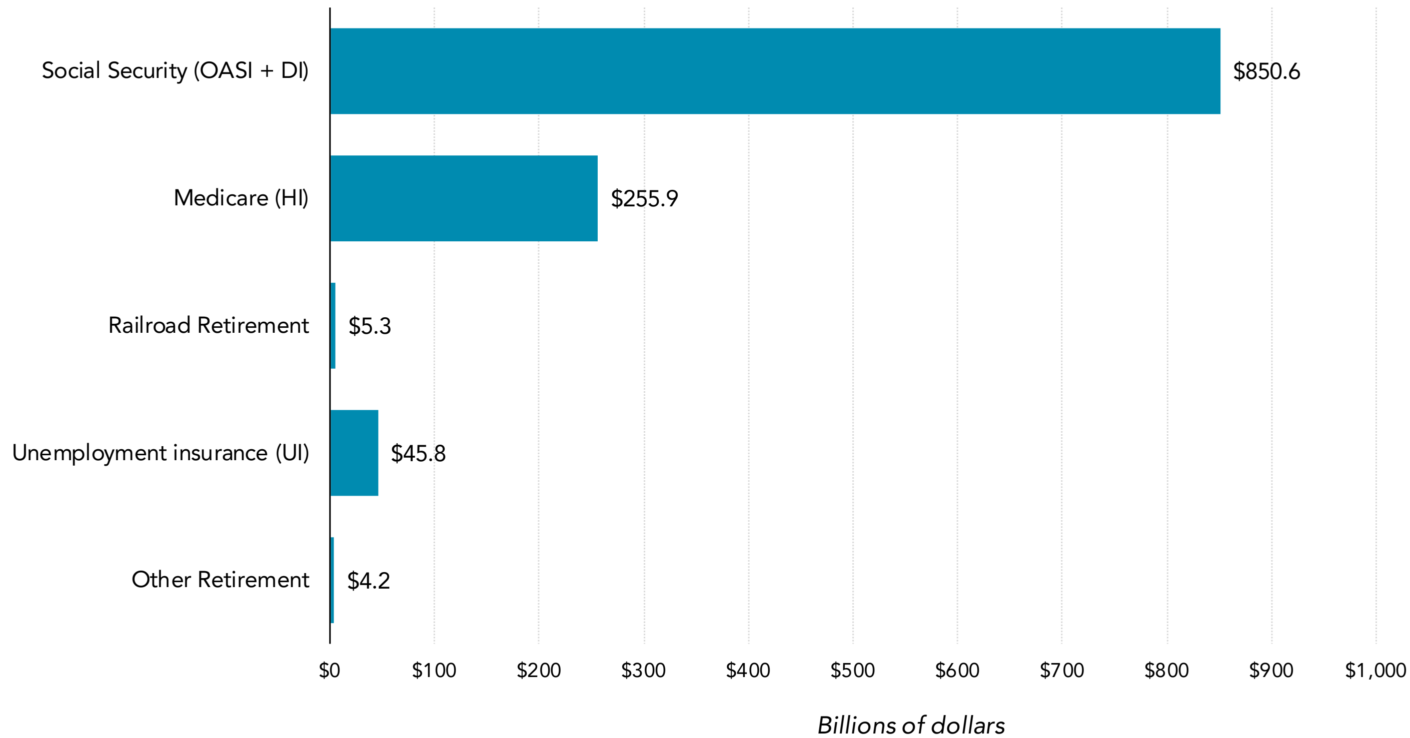
What are the major federal payroll taxes, and how much money do they raise?

Over time, Social Security taxes have become a major share of federal revenues. When the tax was first collected in 1937, the combined payroll tax rate was 2.0 percent; it raised $765 million (about $13.1 billion in 2017 dollars). In 2017, OASDI taxes totaled over $850 billion and represented 25.7 percent of total federal receipts (figure 1).

FIGURE 1

Federal Social Insurance (Payroll Tax) and Retirement Receipts

Billions of dollars, fiscal year 2017



Source: Office of Management and Budget, Historical Tables, "Table 2.4 Composition of Social Insurance and Retirement Receipts and of Excise Taxes: 1940–2023," 2018.
Note: OASI: Old-Age and Survivors Insurance; DI: Disability Insurance; HI: Hospital Insurance.

HOSPITAL INSURANCE

The hospital insurance (HI) program, or Part A of Medicare, covers inpatient hospital visits and other health care services for the elderly and some others suffering from specified maladies. Federal costs for other parts of Medicare, such as Part B, which covers doctors' and other providers' fees, are not covered by payroll taxes but mainly by general revenues.

The HI program is financed mainly through payroll taxes on workers. Employers and employees each contribute 1.45 percent of the worker's wages toward the HI trust fund for a combined rate of 2.9 percent (table 1). The cap on wages subject to the HI tax was removed in 1994. Also, beginning in 2013, single households earning more than $200,000 and married households earning more than $250,000 contributed an additional 0.9 percent of earnings over those thresholds (there is no employer portion for this "surtax"). In 1966, the first year of HI tax collections, the combined tax rate was 0.7 percent, and collections totaled $1.9 billion (about $14.3 billion in 2017 dollars). In 2017, HI taxes totaled $255.9 billion.

UNEMPLOYMENT INSURANCE

Unemployment insurance (UI) provides insured workers with benefits if they are involuntarily unemployed and meet eligibility requirements. UI programs are run by the states in partnership with the federal government. To finance benefits and program expenses, both the states and the federal government deposit payroll taxes into a federal trust fund.

The federal payroll tax rate is 6.0 percent on the first $7,000 of covered wages, but tax credits reduce the effective federal tax rate to 0.6 percent (table 1). State unemployment tax rates and wage bases vary but are usually below 4.0 percent and are on low wage bases.

In 2017, federal UI taxes totaled about $45.8 billion.

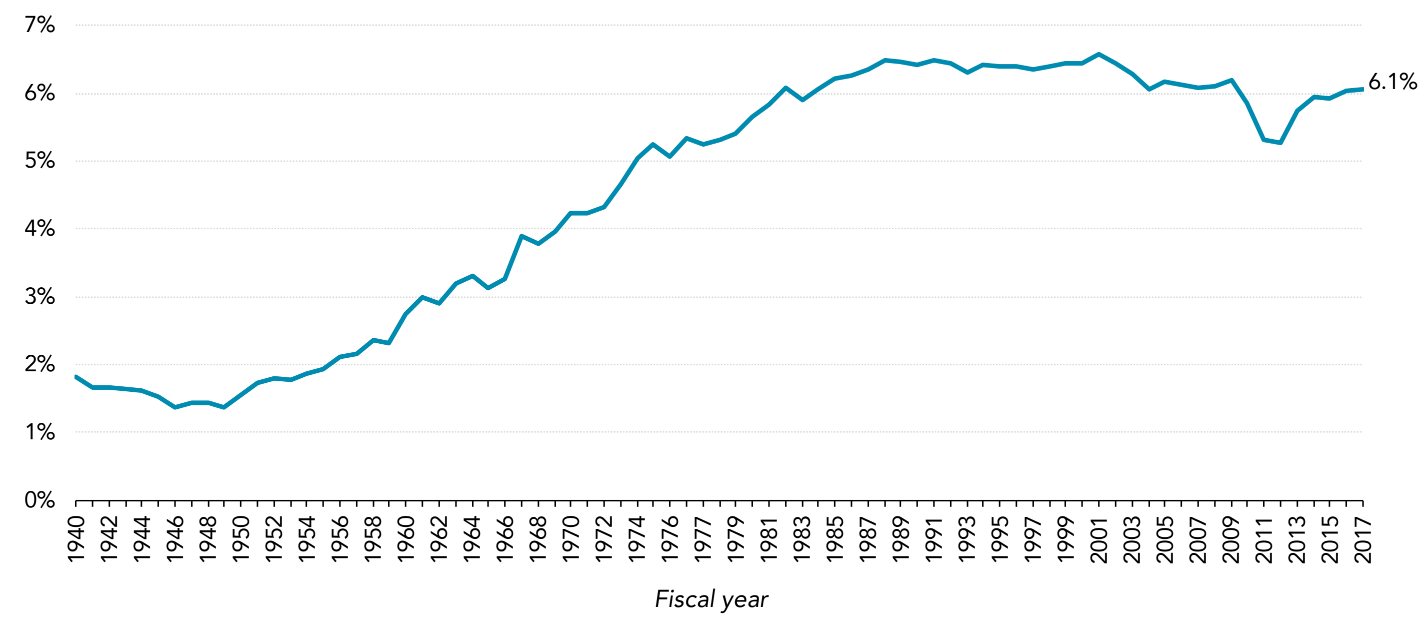
OTHER RETIREMENT PROGRAMS

Payroll taxes fund a handful of other retirement programs. The Social Security Administration operates the largest of these, a retirement program for the railroad industry that functions similarly to Social Security. Retirement programs for federal employees absorb most of the rest of payroll tax receipts.

FIGURE 2

Federal Social Insurance (Payroll Tax) and Retirement Receipts

Share of GDP, fiscal years 1940–2017



Source: Office of Management and Budget, Historical Tables, "Table 2.1-Receipts by Source: 1934–2023" and "Table 10.1-Gross Domestic Product and Deflators Used in the Historical Tables: 1940–2023," 2018.

Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

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Key Elements of the U.S. Tax System

Q. What is the unemployment insurance trust fund, and how is it financed?

A. Unemployment insurance assists workers who become involuntarily unemployed and meet specified eligibility requirements. Unemployment insurance programs are run as federal-state partnerships financed through payroll taxes.

The federal unemployment insurance (UI) trust fund finances the costs of administering unemployment insurance programs, loans made to state unemployment insurance funds, and half of extended benefits during periods of high unemployment. Unemployment insurance programs pay benefits to covered workers who become involuntarily unemployed and meet specified eligibility requirements, such as actively looking for work.

UI is structured as a partnership between the federal government and states and territories. States and territories set the parameters of their unemployment programs within federal guidelines, including payroll tax rates and wage bases for covered workers. State unemployment insurance taxes are paid by employers and remitted to the federal UI trust fund, where each state has a separate account for covering normal unemployment insurance benefits.

In addition, a 6 percent federal payroll tax, known as the Federal Unemployment Tax Act (FUTA) tax, is levied on the first $7,000 of covered workers' earnings. Employers remit the tax but can claim credits against 5.4 percentage points of FUTA taxes paid in states with unemployment programs that meet federal standards (currently all states) The effective FUTA tax rate thus shrinks to 0.6 percent, or a maximum of $42 per worker. The federal fund is used to cover administrative expenses, make loans to states that deplete their own reserves, and cover half of extended unemployment benefits made available when states experience prolonged periods of high unemployment. (States cover the other half of these extended benefits.)

States can borrow from the federal fund if their own reserves are insufficient. When the Great Recession and the long period of high unemployment that followed hit state UI reserves particularly hard, 36 states borrowed from the federal fund. By the start of 2018, all states but California (and the US Virgin Islands) had repaid their outstanding balances. Loans from the federal fund can be repaid by reducing the credit employers can claim against FUTA taxes and through other add-ons. States can also take private loans to shore up reserves. At the beginning of 2018, three states—Michigan, Pennsylvania, and Nevada—had outstanding private loans.

Key Elements of the U.S. Tax System

What is the unemployment insurance trust fund, and how is it financed?

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Key Elements of the U.S. Tax System

Q. What are the Social Security trust funds, and how are they financed?

A. They provide cash benefits to the elderly and disabled as well as their spouses and dependents, and they are funded chiefly through payroll taxes.

There are two Social Security trust funds: old-age and survivors insurance (OASI) and disability insurance (DI), though the two are often analyzed together as Old-Age, Survivors, and Disability Insurance (OASDI). The funds finance benefits for eligible retired and disabled workers and their spouses, dependents, and survivors. When revenue dedicated to financing OASI and DI exceeds program expenses, the surplus is credited to the respective trust funds, which invest in special interest-bearing Treasury bonds. When program costs exceed receipts, the Social Security Administration can redeem its bonds to cover expenses, until it runs out of bonds. The US Department of the Treasury pays its obligation to the trust funds from general government funds.

TABLE 1

Social Security Trust Fund Receipts, Expenditures, and End of Year Assets

Billions of Dollars, 2017

Source	OASI	DI	Total
Asset reserves at the end of 2016	**$2,801**	**$46**	**$2,848**
Total income in 2017	**$826**	**$171**	**$997**
Net payroll tax contributions	$707	$167	$874
Reimbursement from General Fund of the Treasury	*	*	*
Taxation of benefits	$36	$2	$38
Interest	$83	$2	$85
Total expenditures in 2017	**$807**	**$146**	**$953**
Benefit payments	$799	$143	$942
Railroad Retirement financial interchange	$4	$0	$5
Administrative expenses	$4	$3	$7
Net increase in asset reserves in 2017	$19	$25	$44
Asset reserves at the end of 2017	**$2,820**	**$72**	**$2,892**

Source: Social Security Annual Trustees Report, 2018, Table II.B1.

* Less than $50 million

OASDI = old-age and survivors insurance; DI = disability insurance

Key Elements of the U.S. Tax System

What are the Social Security trust funds, and how are they financed?

PAYROLL TAXES: FICA AND SECA

The Social Security trust funds are financed chiefly through payroll taxes on workers covered by the OASDI program. Employers and employees each contribute 5.3 percent of the employee's taxable wages for OASI and 0.9 percent for DI coverage as part of what are sometimes called Federal Insurance Contributions Act (FICA) taxes. Up to $128,400 in wages is subject to FICA taxes, a threshold updated for average wage growth each year. (Revenue from a separate 1.45 percent FICA tax is dedicated to the Medicare hospital insurance trust fund. There is no wage cap for the Medicare tax.) Because the employer portion of the tax raises the cost of hiring workers, economists believe that this tax is passed on to workers in the form of lower compensation. Thus, workers effectively bear the entire tax.

Self-employed workers covered by Social Security contribute both the employer and employee portions of the tax under the Self-Employment Contributions Act (SECA) but can deduct the employer portion from their federal taxable income, just as other employees exclude employer FICA contributions from their taxable income.

OTHER FINANCING SOURCES

Social Security benefits are partially taxable for beneficiaries whose incomes exceed a threshold. The revenues are remitted to the OASI, DI, and HI trust funds. The trust fund balances also earn interest from special interest-bearing Treasury bonds. Congress sometimes adds to the trust funds directly from general funds. For example, when the payroll tax was cut temporarily as a stimulus measure in 2011 and 2012, the general funds reimbursed the trust funds for lost revenue.

TRUST FUND SOLVENCY AND GOVERNMENT-WIDE DEFICITS

Both the OASI and DI trust funds face shortfalls as benefits currently exceed the taxes paid into each (figure 1). In the near future, benefits from the combined OASDI trust fund will exceed revenues, including interest payments from the Treasury. In the 2018 Trustees' Report, Social Security's actuaries projected that the DI trust fund will be exhausted by 2032 and the OASI trust fund will be exhausted by 2034. If either event occurs, the Social Security Administration will only be able to pay a portion of benefits from payroll taxes collected—about three-quarters of promised benefits in the case of Social Security.

When the DI fund came close to depletion in 1994, Congress diverted some of the OASI fund's payroll tax receipts to the DI fund to maintain its solvency. Legislators took this step again in 2015, transferring funds from the OASI trust fund to extend the DI fund's solvency.

To restore long-term trust fund solvency, policymakers will need to change Social Security through some combination of raising the payroll tax rate, reducing benefits, and tapping other sources of revenue. To ameliorate the ever-growing gap between benefits relative to taxes, which adds to total government deficits, policymakers need to act soon. The sooner policymakers make adjustments, the less dramatic those adjustments will need to be.

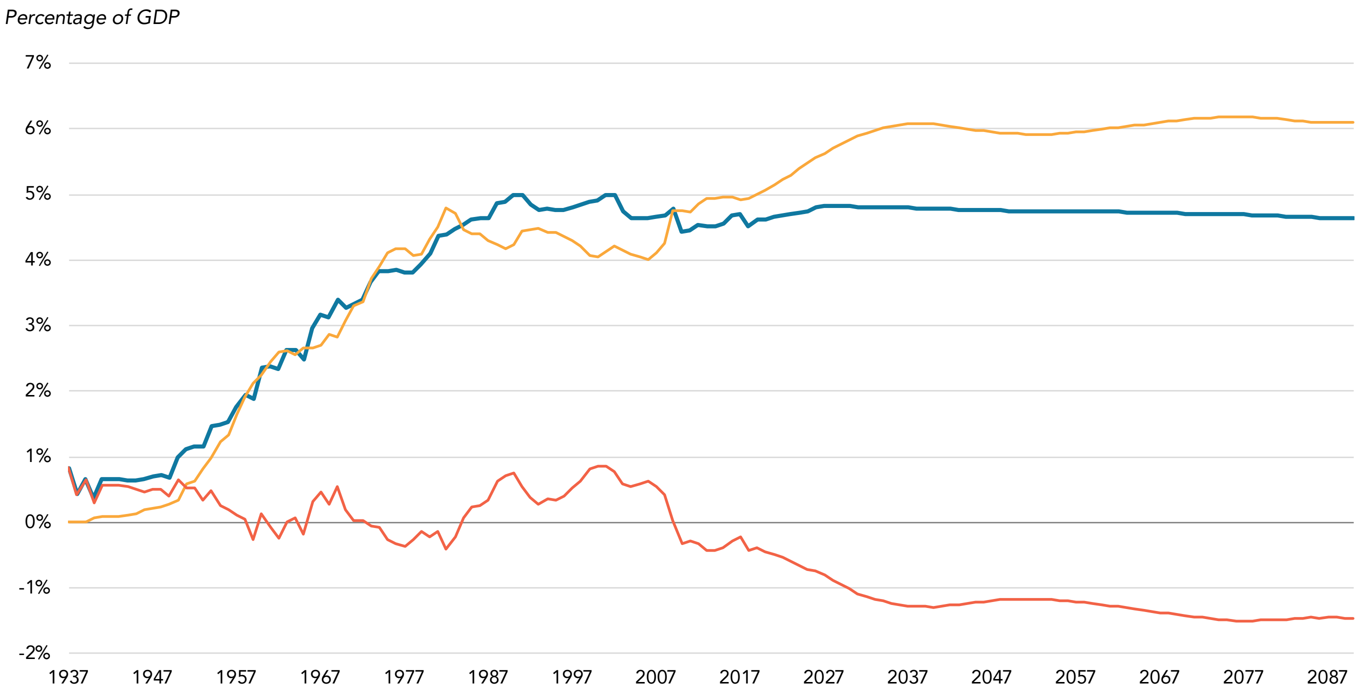
Key Elements of the U.S. Tax System

What are the Social Security trust funds, and how are they financed?

FIGURE 1

OASDI Cost and Income as a Percentage of GDP

1937–2090



Source: Calculations from data from 2017 OASDI Trustees' Report, *Annual Supplement to the Social Security Bulletin,* and BEA.

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Key Elements of the U.S. Tax System

Q. Are the Social Security trust funds real?

A. Social Security trust funds are real and hold real Treasury securities for which the federal government has an obligation to pay. They reflect any accumulated excess of Social Security taxes plus other revenues, such as interest received, over expenditures. At the same time, the trust funds "fund" only a tiny portion of outstanding obligations. The trust funds are invested in special-issue Treasury securities backed by the full faith and credit of the federal government.

Social Security was designed primarily as a "pay-as-you-go" system. Instead of prefunded accounts for individuals, contributions from current workers pay most of the benefits. For the most part, money going into the system immediately goes out to pay for benefits.

When Social Security's receipts from payroll taxes and other sources exceed program costs, as when the baby boom generation dominated the workforce, excess funds have purchased interest-bearing special-issue US Treasury bonds. In effect, the Social Security trust fund lends money to the general fund.

Where does the money go? When the non–Social Security part of government is running deficits, the money funds all other government activities. When the trust funds themselves run deficits, they add to these other non–Social Security deficits to produce an even larger unified fund deficit. Because these special-issue bonds are essentially both sold and held by the government, aren't publicly traded like other financial assets, and represent IOUs from the government, some people believe that the trust funds are nothing more than an accounting fiction.

Another factor further confuses the issue. Because the trust funds represent an asset to one side of government (the Social Security Administration) and a liability to another side of government (the general fund), some accounting presentations make the effect of the trust funds on the budget look "neutral," when in fact future obligations are to be paid.

So are the trust funds real? Yes. They have legal consequences for the Treasury and are backed by the full faith and credit of the federal government, just like any other Treasury bond. When the Social Security Administration redeems the bonds, the government has a legal obligation to pay the money back with interest, with no additional appropriation by Congress required.

The trust funds are not a free lunch for taxpayers. Money from the general fund used to repay debts to the

Are the Social Security trust funds real?

trust funds cannot be used for other purposes, like building roads or providing for national defense. And as an additional outlay for the government, those general fund payments increase the Treasury's need to borrow from the public, increasing federal deficits and adding burdens on future taxpayers.

For all the heat about whether the trust funds exist, the debate misses a larger issue: the long-term fiscal challenges posed by Social Security and Medicare are not caused by inadequate trust funds, which will be depleted after only a few years of drawdown, but to decades-long imbalances between promised benefits and the revenues required to fund those benefits.

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Q. What is the Medicare trust fund, and how is it financed?

A. The Medicare trust fund finances health services for beneficiaries of Medicare, a government insurance program for the elderly, the disabled, and people with qualifying health conditions specified by Congress. The trust fund is financed by payroll taxes, general tax revenue, and the premiums enrollees pay.

The Medicare trust fund comprises two separate funds. The hospital insurance trust fund is financed mainly through payroll taxes on earnings and income taxes on Social Security benefits. The Supplemental Medical Insurance trust fund is financed by general tax revenue and the premiums enrollees pay.

HOSPITAL INSURANCE TRUST FUND

The hospital insurance (HI) trust fund, also known as Part A of Medicare, finances health care services related to stays in hospitals, skilled nursing facilities, and hospices for eligible beneficiaries—mainly people over age 65 with a sufficient history of Medicare contributions.

The HI trust fund had receipts of $299.4 billion and a balance of $202 billion at the end of 2017 (table 1). The fund's chief revenue sources are payroll taxes and income from the taxation of Social Security benefits. Interest payments on trust fund balances, premiums from voluntary enrollees ineligible for Medicare coverage based on their earnings records, transfers from the general fund and the Railroad Retirement account, and miscellaneous receipts supply the remainder of revenues.

SUPPLEMENTAL MEDICAL INSURANCE TRUST FUND

The Supplemental Medical Insurance (SMI) trust fund finances two voluntary Medicare programs: Part B, which mainly covers physician services and medical supplies, and Part D, the newer prescription drug program.

The SMI trust fund received $405.8 billion in revenues and had $87.7 billion in assets at the end of 2017 (table 2). Unlike the HI fund, no payroll taxes are dedicated to SMI. Instead, the fund's chief revenue sources are contributions from the general fund (receipts from other sources, such as individual income taxes, corporate taxes, and excise taxes), premiums from participants (there are separate premiums for Parts B and D), and a small amount of interest on trust fund balances and miscellaneous receipts. Because the bulk of SMI's funding comes from the general fund, the trust fund balance mainly serves to cover temporary shortfalls and is kept low. High reserves are not required as long as general fund revenues and borrowing automatically rise with costs.

Key Elements of the U.S. Tax System

What is the Medicare trust fund, and how is it financed?

TABLE 1

Hospital Insurance Trust Fund Receipts, Expenditures, and End of Year Assets

Billions of dollars, 2017

Sources	Amount
Assets at end of 2016	**$199**
Total income	**$299**
Payroll taxes	$262
Interest	$7
Taxation of benefits	$24
Premiums	$4
General revenue	$1
Transfers from states	$0
Other	$2
Total expenditures	**$297**
Benefits	$293
Hospital	$145
Skilled nursing facility	$28
Home health care	$7
Physician fee schedule services	$0
Private health plans (Part C)	$95
Prescription drugs	$0
Other	$19
Administrative expenses	$3
Net change in assets	**$3**
Assets at end of 2017	**$202**

Source: Centers for Medicare and Medicaid Services (2018).

Key Elements of the U.S. Tax System

What is the Medicare trust fund, and how is it financed?

TABLE 2

Supplementary Medical Insurance Trust Fund Receipts, Expenditures, and End of Year Assets

Billions of Dollars, 2017

Sources	Part B	Part D	Total
Assets at end of 2016	**$88**	**$8**	**$96**
Total income	**$306**	**$100**	**$406**
Payroll taxes	$0	$0	$0
Interest	$2	$0	$2
Taxation of benefits	$0	$0	$0
Premiums	$82	$16	$97
General revenue	$217	$73	$291
Transfers from states	$0	$11	$11
Other	$5	$0	$5
Total expenditures	**$314**	**$100**	**$414**
Benefits	$309	$100	$409
Hospital	$53	$0	$53
Skilled nursing facility	$0	$0	$0
Home health care	$12	$0	$12
Physician fee schedule services	$69	$0	$69
Private health plans (Part C)	$115	$0	$115
Prescription drugs	$0	$100	$100
Other	$60	$0	$60
Administrative expenses	$5	$0	$5
Net change in assets	**-$8**	**$0**	**-$8**
Assets at end of 2017	**$80**	**$8**	**$88**

Source: Centers for Medicare and Medicaid Services (2018).

SOLVENCY AND BUDGET PRESSURES

Like the Old-Age and Survivors Insurance and Disability Insurance trust funds, the HI trust fund faces long-term deficits (figure 1). (The SMI fund, primarily financed by general revenue, does not face these trust fund imbalances, though it still adds growing pressure to the overall budget.) As the number of Medicare beneficiaries increases from about 58.4 million in 2017 to nearly 80 million by 2030, the number of workers per beneficiary will decline from 3.1 to 2.4. The cost of health care has increased rapidly as well—though this dynamic has slowed but not stopped during and following the Great Recession—putting further pressure on program costs. HI trust expenditures exceeded taxes for several years up to 2016, and though these outflows and inflows will roughly stabilize for a few years, the fund is projected to be exhausted by 2027. These pressures now and in the future will force lawmakers to find ways to finance promised benefits or cut services or provider payment rates.

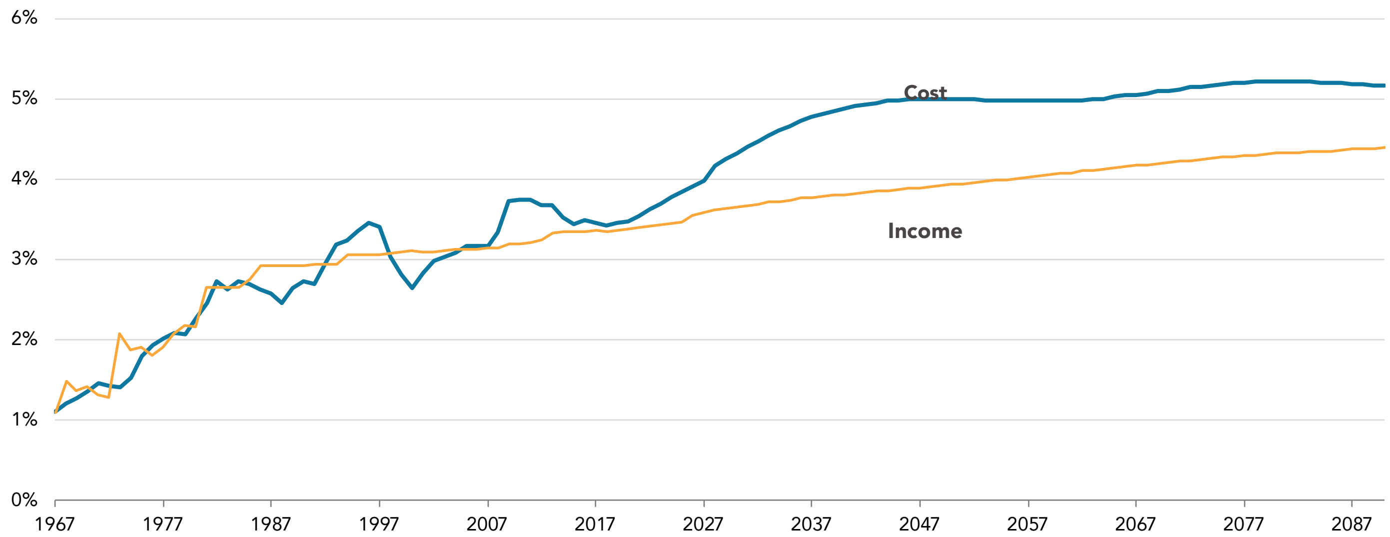
Key Elements of the U.S. Tax System

What is the Medicare trust fund, and how is it financed?

FIGURE 1

Hospital Insurance Cost and Income as a Percentage of Taxable Payroll

1967-2090



Source: Centers for Medicare and Medicaid Services. "2018 Expanded and Supplemental Tables."

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