

The Federal Payroll Tax: A Primer

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Key Findings

- Payroll taxes are a significant source of revenue for the US federal government, representing one-third of all revenue raised by the tax system.
- Accounting for federal payroll taxes that fund Social Security and Medicare, and including the employer's portion, most earners face a combined federal payroll rate of 15.3 percent on their wage income, a rate that has remained unchanged since 1990.
- The economic literature shows that, in the long run, payroll taxes are largely borne by workers and are one of the least harmful taxes the government imposes because they are levied on a broad tax base and avoid penalizing saving and investment.
- Though policymakers often propose payroll tax holidays to stimulate the economy in the short run, they are usually ineffective (as evidenced by the 2010 payroll tax holiday), although payroll tax cuts on the employer side could boost employment.
- Concerns surrounding the depletion of the Social Security and Medicare Hospital Insurance trust funds have led to renewed interest in payroll tax reform, with some policymakers and analysts suggesting raising or even eliminating the payroll tax cap to subject more income to the payroll tax.
- Such proposals involve trade-offs: notably, that elimination of the payroll tax cap would increase top tax rates substantially on high-income earners and potentially reduce economic growth.

Introduction

Federal payroll taxes apply to wages and salaries, and they fund certain social insurance programs. Workers who have scrutinized their pay stubs will recognize payroll taxes as FICA (Federal Insurance Contributions Act) and MEDFICA (Medicare Federal Insurance Contributions Act). FICA funds Social Security, and MEDFICA funds Medicare.

Both Social Security and Medicare are approaching fiscal crises in the coming years, putting renewed attention on payroll taxes as a means of closing the funding gaps. Currently, the Old-Age and Survivors Insurance (OASI) trust fund, commonly referred to as Social Security, will be depleted by 2033; at that point, it will only be able to pay 77 percent of scheduled benefits.¹ The Medicare Hospital Insurance (HI) trust fund will also be depleted by 2033, and will only be able to provide 89 percent of its insurance benefits.²

With changes to payroll taxes likely to be part of the toolkit for reform, both policymakers and the public would benefit from understanding how the payroll tax works, who pays it, how it affects economic growth, and how much of the funding gap payroll tax increases could close.

How Do Payroll Taxes Work?

The federal government levies five different payroll taxes. Unlike the US federal income tax system, which applies to income after adjustments for certain deductions and credits, payroll taxes apply to *gross* wages and salaries. Because it makes no adjustments for deductions or credits, the payroll tax base is relatively broad, and it serves as a significant source of federal tax revenue. In 2023, 83 percent of wages and salaries were subject to the payroll tax, and this share has been stable over the past two decades (Figure 1).³ Note that the payroll tax base of salaries and wages does not include certain kinds of employee compensation, such as fringe benefits.

The Federal Insurance Contributions Act (FICA) applies a 12.4 percent tax on payroll, split between the employee and the employer, to support both the OASI and the Disability Insurance (DI) trust funds.⁴ The tax applies only to the first \$184,500 in wage and salary income for 2026 and is adjusted for inflation every year.⁵

An additional 2.9 percent payroll tax, also split between the employee and employer, is applied under MEDFICA to finance the Medicare HI trust fund.⁶ Unlike FICA, which is subject to a payroll tax cap, the Medicare tax applies to all earned income. Together, FICA and MEDFICA bring the total payroll tax to 15.3 percent of wage and salary income for most earners. Self-employed workers are subject to the same tax under the Self-Employed Contributions Act (SECA), although they may deduct the employer-side portion, 7.65 percent, from their income.⁷

1 Social Security Administration, "Social Security Board of Trustees: Projection for Combined Trust Funds One Year Sooner than Last Year," Jun. 18, 2025. <https://www.ssa.gov/news/en/press/releases/2025-06-18.html>.

2 Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, "2025 Annual Report," Center for Medicare and Medicaid Services, 2025, <https://www.cms.gov/oact/tr/2025>.

3 Social Security Administration, *Annual Statistical Supplement 2024*, Table 4.B1.

4 Social Security Board of Trustees, "Social Security Board of Trustees: Projection for Combined Trust Funds One Year Sooner than Last Year," Social Security Administration, Jun. 18, 2025, <https://www.ssa.gov/news/en/press/releases/2025-06-18.html>.

5 Ibid.

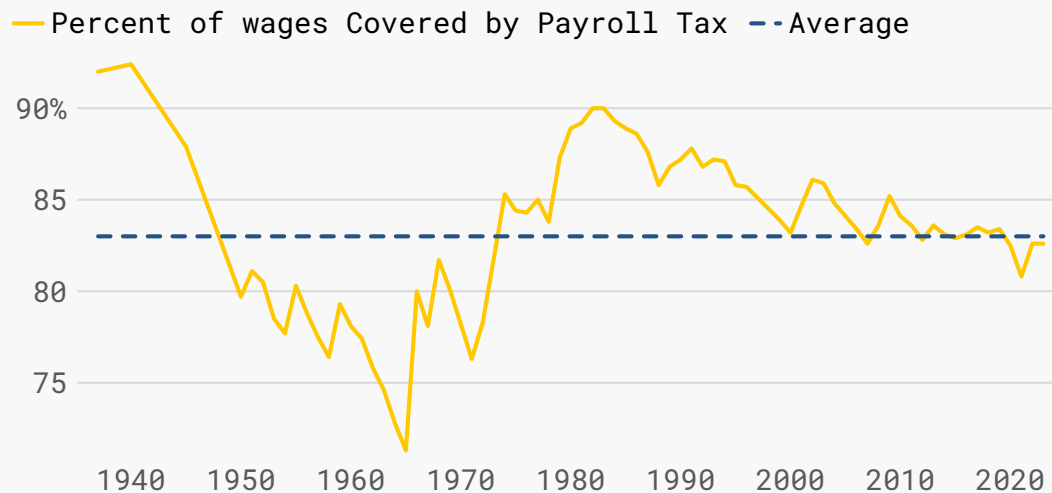
6 Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, "2025 Annual Report," Center for Medicare and Medicaid Services, 2025, <https://www.cms.gov/oact/tr/2025>.

7 Social Security Administration, "What are FICA and SECA Taxes?," Jan. 2, 2025, <https://www.ssa.gov/faqs/en/questions/KA-02375.html>.

Figure 1.

Payroll Tax Has on Average Covered 83 Percent of Wages

Percent of Wages Covered by Payroll Tax, 1937-2023



Source: Social Security Administration, *Annual Statistical Supplement 2024*, Table 4.B1; Tax Foundation calculations.



Certain high-income earners are also subject to the additional Medicare tax. It was introduced as part of the Affordable Care Act in 2009 to support the Medicare program and first took effect in 2013.⁸ Unlike MEDICARE, the revenues raised through the additional Medicare tax are not directly earmarked for the HI trust fund. Single and joint filers with more than \$200,000 or \$250,000 in earned income, including self-employed earners, must pay an additional 0.9 percent in payroll taxes on income exceeding those thresholds.⁹ Unlike the payroll tax cap that applies to FICA, the thresholds for the additional Medicare tax are not indexed for inflation, subjecting an increasing share of earners to the tax over time.

Finally, the first \$7,000 of an employee's annual wages or salary, unadjusted for inflation, are subject to the 6 percent Federal Unemployment Tax Act (FUTA) tax, used to fund the federal unemployment insurance program.¹⁰ This is paid by the employer and, as such, does not show up as withheld income on a worker's paystub. However, as the federal unemployment insurance program is largely financed by state payroll taxes, employers may claim a 5.4 percent credit for state unemployment taxes paid, effectively reducing the FUTA rate on payroll to 0.6 percent.¹¹

8 Internal Revenue Service, "Question and Answers for the Additional Medicare Tax," accessed Dec. 16, 2025, <https://www.irs.gov/businesses/small-business-es-self-employed/questions-and-answers-for-the-additional-medicare-tax>.

9 Ibid.

10 Paycom, "Federal Unemployment Tax Act: What is It and How is It Calculated?," Dec. 26, 2024, <https://www.paycom.com/resources/blog/what-is-futa-tax/?msoclid=26837511c3b36f4f33df632ec21a6e9b>.

11 Ibid.

Table 1. Federal Payroll Taxes in the US

Type	Description	Rate	Taxable Maximum in 2026
FICA	Funds the Old-Age, Survivors, and Disability Insurance (OASDI) trust funds, also known as Social Security	12.4%, split between employee and employer	\$184,500
MEDFICA	Funds the Medicare Hospital Insurance (HI) trust fund	2.9%, split between employee and employer	None applied
Additional Medicare Tax	Imposed on high earners to support Medicare, not directly earmarked for the HI trust fund	0.9%	Applies to earned income over \$200,000/\$250,000 for single/joint filers, not adjusted for inflation
SECA	The combined FICA and MEDFICA taxes that self-employed workers pay	15.3%	Same rules and FICA and MEDFICA
FUTA	Paid by employers to fund the federal unemployment insurance program	6%, reduced to 0.6% for employers that claim credit for state unemployment taxes paid	\$7,000, not adjusted for inflation

Source: Internal Revenue Service; Social Security Administration; Center for Medicare and Medicaid Services.

In total, federal payroll taxes accounted for one-third of federal tax revenue in fiscal year 2025, or about 5.8 percent of US GDP.¹² Payroll taxes are the second largest source revenue for the federal government: they are below individual income taxes (51 percent of all revenues) but above the corporate income tax (9 percent of all revenues).¹³ Looking at the expenditure level, current payroll taxes have been insufficient to cover outlays of the Social Security and Medicare programs, forcing the government to borrow money to make up the difference. In 2024, according to the latest Social Security and Medicare Trustees Report, the OASDI trust funds ran a deficit of \$67.0 billion, while the HI trust fund ran a deficit of \$28.7 billion. These deficits are projected to grow over the next 75 years.¹⁴

12 Congressional Budget Office, "Monthly Budget Review: Summary for Fiscal Year 2025," Dec. 8, 2025, <https://www.cbo.gov/system/files/2025-11/61307-MBR-FY25-final.pdf>.

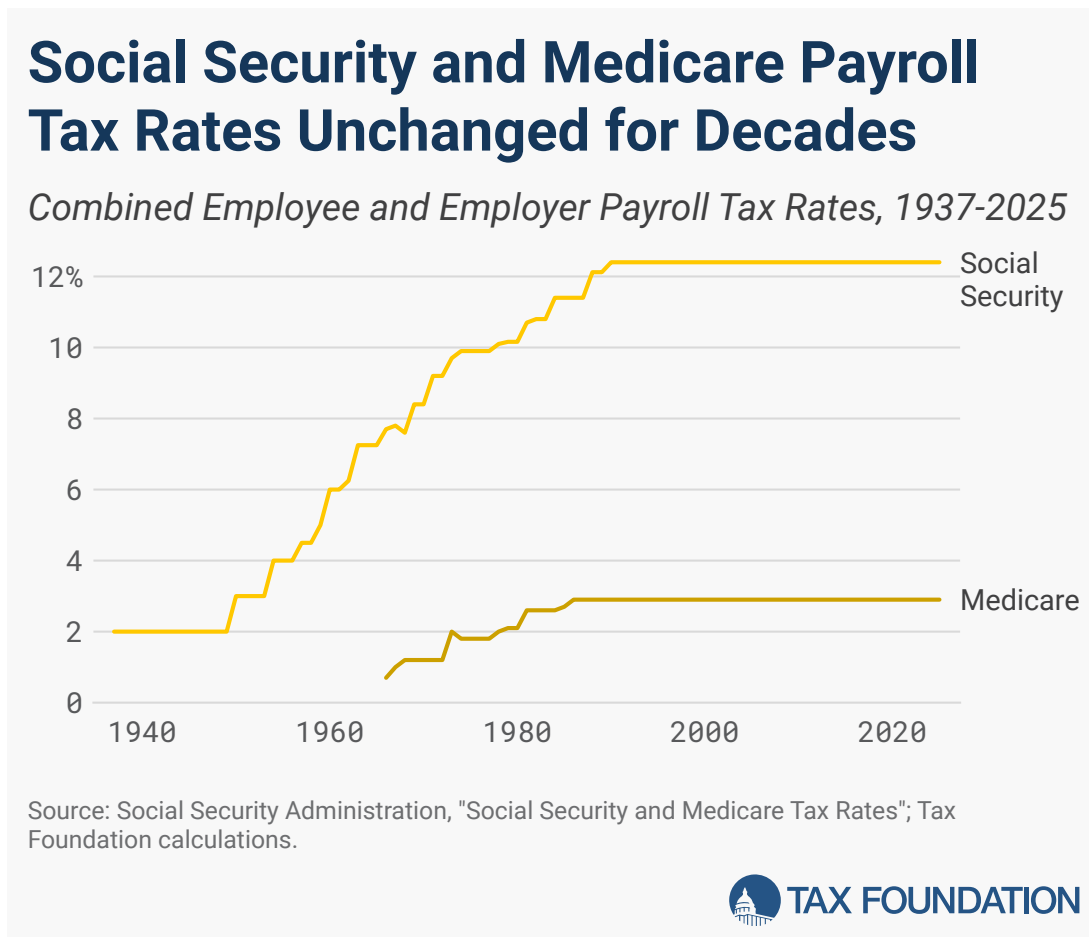
13 Ibid.

14 Social Security and Medicare Boards of Trustees, "A Summary of the 2025 Annual Reports," Social Security Administration, 2025, <https://www.ssa.gov/OACT/TR-SUM/index.html>.

The Payroll Tax over Time

The Social Security payroll tax was created in 1937 by the Social Security Act of 1935, and the Medicare tax was created by the Social Security Amendments of 1965. In earlier decades, both taxes were frequently updated to address funding concerns; however, they have now remained unchanged for decades.

Figure 2.



Social Security

The Social Security payroll tax was first imposed in 1937 at 2 percent of payroll for an individual's first \$3,000 in earnings (\$67,000 in today's dollars), split between the employee and employer.¹⁵ Self-employed workers were exempt.

The rate and payroll tax cap remained the same throughout the 1940s. In 1950 and 1951, Congress increased the payroll tax to 3 percent on the first \$3,600 in earnings (\$48,000 in today's dollars).¹⁶ These statutory adjustments were not enough to keep up the rising inflation that occurred over the next two

¹⁵ Social Security Administration, "Contribution and Benefit Base," <https://www.ssa.gov/OACT/COLA/cbb.html#Series>; Social Security Administration, "Social Security and Medicare Tax Rates," <https://www.ssa.gov/OACT/ProgData/taxRates.html>.

¹⁶ Social Security Administration, "Social Security and Medicare Tax Rates."

decades, so Congress eventually implemented automatic indexing for the payroll tax cap in 1975, indexing it to average wage growth in the economy.¹⁷

In 1954, Congress increased the payroll tax rate on wage and salary earners to 4 percent and extended the payroll tax to self-employed workers under SECA, but at a lower 3 percent of earnings. The payroll tax rate for self-employed workers remained lower than the rate for other workers until the 1983 Social Security Amendments.¹⁸

From 1950 to 1977, Congress periodically made changes to the Social Security payroll tax to address imbalances. Over that 27-year period, lawmakers increased the payroll tax eight times.¹⁹ However, the stagflation of the 1970s caused the trust fund to rapidly deplete, as the rising unemployment rate reduced payroll tax revenue. At the same time, an earlier reform had overcorrected for inflation, increasing benefits sharply.²⁰

Ultimately, this led to the 1977 Social Security Amendments, which attempted to offer a permanent fix to imbalances that would not require regular adjustments to the benefits. The solution was to adjust the initial benefits for growth in the average wage in the economy and adjust the payroll tax cap by the same wage index.²¹

The amendments also made a new rate schedule for the payroll tax, which would phase in the changes over the next decade. The 1983 Social Security Amendments, the last major reform to Social Security, accelerated the phase-ins to address short-term insolvency concerns, with the last scheduled increase occurring in 1990.²² Since that year, Congress has not made any further changes to the payroll tax rate (Figure 2).

Medicare

The Social Security Amendments of 1965 created Medicare and a new payroll tax to fund it. The Medicare payroll tax was initially set at 0.7 percent, split between the employee and employer, and rose periodically over the next several decades.²³ The Medicare tax was subject to the same payroll tax cap as Social Security until 1990, when it was decoupled from the Social Security program.²⁴ In 1993, lawmakers removed the cap entirely, subjecting all earned income to the Medicare payroll tax.²⁵ Today, the Medicare payroll tax applies a total payroll tax of 2.9 percent to earned income for most workers, a rate that has remained unchanged since 1986, while higher earners pay an additional 0.9 percent.²⁶

17 Kevin Whitner and Dave Shoffner, "The Evolution of Social Security's Taxable Maximum," Social Security Administration, 2011, <https://www.ssa.gov/policy/docs/policybriefs/pb2011-02.html>.

18 Ibid.

19 Ibid.

20 Alex Durante, "Social Security: Lessons for Reform," Tax Foundation, Sep. 24, 2024, <https://taxfoundation.org/research/all/federal/social-security-reform-options/>.

21 Ibid.

22 John Svahn and Mary Ross, "Social Security Amendments of 1983: Legislative History and Summary of Provisions," Social Security Administration, 1983, <https://www.ssa.gov/policy/docs/ssb/v46n7/v46n7p3.pdf>.

23 Ibid.

24 Zhe Li, "Social Security: Raising or Eliminating the Taxable Earnings Base," Congressional Research Service, 2021, <https://www.congress.gov/crs-product/RL32896>.

25 H.R. 2264, Omnibus Budget Reconciliation Act of 1993.

26 Social Security Administration, "Social Security and Medicare Tax Rates," <https://www.ssa.gov/OACT/ProgData/taxRates.html>.

Economic Incidence of the Payroll Tax

The true economic burden of the payroll tax is hidden from most taxpayers, because they are only exposed to the employee share that appears on their pay stubs. This may lead some to conclude that their employer always “pays” the other half, as that is what is specified in law. However, legal incidence is different from economic incidence. Economic theory suggests that *employees* bear the full payroll tax because the wage offered to them with an employer-side payroll tax is lower than the wage that would be offered if the employer-side payroll tax were not imposed. In other words, employees pay the employer-side of the payroll tax through lower wages.

This theoretical result, however, has been difficult to validate empirically, especially in the US, which has not seen federal payroll tax changes in several decades. Typically, most researchers rely on state variation in unemployment insurance systems to measure the incidence of payroll tax changes. But because these generally examine only short-run effects, they do not shed much light on who bears the burden in the long run.

Other scholars have attempted to measure payroll tax incidence by looking at other countries. A recent paper examined Finnish payroll data to estimate the incidence of payroll taxes. The Finnish payroll tax system is unique in that employers face a “discontinuous increase in payroll tax rates if they exceed a set depreciation threshold,” equivalent to a five percentage point increase in the corporate tax rate.²⁷ The variation in the payroll tax rate across the distribution allows the author to identify firms’ responses to payroll tax increases.

The paper finds that Finnish firms respond to the payroll tax increase by reducing employment, mostly among lower-skilled workers, rather than wages as would be predicted under the canonical model. Firms also appeared to reduce their investments as well, due to the complementarities between labor and capital. Overall, the results suggest that while workers are bearing some share of the payroll tax, firms may also bear some of those costs as well. This finding is consistent with other evidence showing wages tend to be slow to adjust, but that is primarily a short-run effect. In the long run, wages are more flexible, so we would expect labor to bear an increasing share of the burden over time.

A Congressional Budget Office analysis estimated that a 1 percentage point increase in the federal payroll tax rate would burden both labor and capital in the short run, with 58 percent of the burden falling on employees, consistent with some of the international evidence that has been found on those short-run effects.²⁸ In the long run, workers would actually bear more than the full burden, 152 percent of the incidence, if the revenue raised were used for noninvestment government spending, such as transfer payments.²⁹ This occurs because additional government spending would crowd out private saving even more. If the revenue were used instead for productive investments or reducing the national debt, the reduction in savings from the tax itself would be balanced by an increase in the capital stock. The increase in the capital stock would make labor productive, partially offsetting some of the decrease in the after-tax wage from the payroll tax, and therefore reducing the burden borne by the worker.

27 Youssed Benzarti and Jakko Harju, “Using Payroll Tax Variation to Unpack the Black Box of Firm-Level Production,” National Bureau of Economic Research Working Paper 26640, 2020, https://www.nber.org/system/files/working_papers/w26640/w26640.pdf.

28 Dorian Carloni, “Revisiting the Extent to Which Payroll Taxes are Passed Through to Employers,” Congressional Budget Office Working Paper 2021-06, 2021, <https://www.cbo.gov/system/files/2021-06/57089-Payroll-Taxes.pdf>.

29 Ibid.

Distributionally, payroll taxes are regressive due to the payroll tax cap. That is, as a percentage of income, lower-income earners pay more in payroll taxes than higher-income earners. Payroll taxes also disproportionately fall on younger and poorer workers. Retirees do not pay payroll taxes, as they are not in the labor force, but receive Social Security benefits that are funded by those current workers' payroll taxes. However, when accounting for the benefits that are paid through Social Security, the overall system is modestly progressive over a lifetime basis: Social Security replaces a higher share of income for poorer retirees relative to richer ones.³⁰

Short-Run Economic Effects of the Payroll Tax

Policymakers often look to payroll tax reductions to stimulate the economy or reverse rising unemployment during recessions. Understanding whether payroll tax changes can effectively accomplish these short-term objectives requires examining how wages and employment adjust in the short run.

In an economy with flexible wages, wages can fall to accommodate reduced demand for labor during a downturn, allowing the market to clear without generating job loss. However, economies in the real world do not have perfectly flexible labor markets due to minimum wages and other labor regulations. Additionally, employers themselves are often reluctant or unable to cut nominal wages, either because of contractual reasons with their employees or concerns that cutting wages would affect employee morale and reduce productivity.³¹ Wages for this reason are said to be “sticky” in the short run.

One way to reduce labor costs on the employer side and accelerate the wage adjustment process would be to temporarily reduce employer-side payroll taxes. The surplus generated from the tax cut gives employers greater flexibility in wages and hiring, and may potentially avoid higher unemployment. In practice, only one country has ever experimented with this policy: Singapore, which temporarily cut its employee share of the payroll tax during the Asian Financial Crisis in the late 1990s.³²

Most countries instead have opted for temporary reductions on the employee-side payroll tax to stimulate the economy, usually described as “payroll tax holidays.” While a reduction in the employee-side payroll tax could increase labor participation or hours worked for employees—since a payroll tax cut increases the after-tax wage and, therefore, the returns to working—advocates for payroll reductions typically defend the policy as a form of fiscal stimulus to boost aggregate demand. Workers increase their consumption due to the tax cut, increasing demand for goods and services to potentially unwind a downturn.

To be effective, economic stimulus like this should generally be “timely, targeted, and temporary.”³³ How well have payroll tax holidays historically performed on these three Ts?

30 Andrew G. Biggs et al., “A Progressivity Index for Social Security,” Social Security Administration, 2009, <https://www.ssa.gov/policy/docs/issuepapers/ip2009-01.html>.

31 Truman Bewley, *Why Don't Wages Fall During a Recession* (Cambridge, MA: Harvard University Press, 1999).

32 Singapore Government Media Release, “CPF Restoration,” National Archives of Singapore, 2001, <https://www.nas.gov.sg/archivesonline/data/pdf-doc/2000101101.htm>.

33 Jason Taylor and Andrea O’Sullivan, “Timely, Target, and Temporary? An Analysis of Government Expansions over the Past Century,” Mercatus Center, Jan. 13, 2015, <https://www.mercatus.org/research/research-papers/timely-targeted-and-temporary-analysis-government-expansions-over-past>.

Consider the last federal payroll tax holidays in 2010. That year, Congress lowered the employee-side payroll tax rate from 6.2 percent to 4.2 percent.³⁴ Funds from general revenues were transferred to the OASI trust fund to make up the difference.

The payroll tax holiday may have ultimately been temporary and timely, but it was poorly targeted. Payroll tax cuts generate windfalls for those who are already employed, providing no benefits for those who are unemployed or not in the labor force. Moreover, while the intention of the payroll tax cut was to increase spending to offset the reduction in aggregate demand, households were more likely to save their stimulus and use it to pay down their accumulated debts.³⁵ As a result, the unemployment rate did not meaningfully fall after the payroll tax cut. While the policy certainly helped improve household balance sheets, the payroll tax holiday was not effective as a fiscal stimulus.

Long-Run Economic Effects of the Payroll Tax

Taxes affect the long-run level of economic output by altering incentives to work and invest, which can affect the supply of labor and of capital. The impact of the payroll tax on the economy occurs through changes in the after-tax wage rate.

As with tax incidence, the long-run economic effects of the payroll tax can be different from what happens in the short term. In general, the payroll tax is one of the more efficient taxes the government imposes for a few key reasons.

First, the payroll tax itself is a kind of flat tax, as it does not impose a system of marginal rate changes akin to the US income tax. Across the earnings distribution, the marginal incentive to earn an additional \$1 in income remains constant, whereas the marginal incentive to earn an additional \$1 of income changes as taxpayers move into different tax brackets across the income tax system. While the payroll tax still reduces work incentives, it does not apply discrete changes in marginal incentives as workers earn more income. The one exception occurs around the payroll tax cap, where income earned in excess of that threshold does not face any additional payroll tax burden.

Second, the payroll tax is applied to a very broad definition of income: all wages and salaries. Unlike the income tax, the payroll tax offers no deductions before the tax is applied and provides no offsetting credits. Whereas many low- and middle-income workers are exempt from the income tax due to the size of deductions and credits, they all pay the payroll tax. The scope of the payroll tax base—while not perfect due to exemptions for certain kinds of employee compensation, such as the tax exclusion for health insurance—allows the government to collect a large amount of revenue with a relatively low rate.

Third, while the income tax funds various kinds of government spending, the revenue raised from the payroll tax is earmarked specifically for Social Security and Medicare. A dedicated fund for these revenues further reduces inefficiency of the payroll tax on the expenditure side.

³⁴ Garrett Watson and Huaqun Li, "A History and Analysis of Payroll Tax Holidays," Tax Foundation, Mar. 31, 2020, <https://taxfoundation.org/blog/payroll-taxes-payroll-tax-holiday/>.

³⁵ Ibid.

Finally, payroll taxes are difficult to evade compared to other kinds of income taxes. All workers, whether they work for someone else or themselves, must pay the payroll tax. Even nonprofit employers, who are exempt from traditional income taxes, also pay the payroll tax. However, some evasion is still possible for self-employed workers. For example, an owner in an S corporation might pay themselves a low wage to evade SECA and then distribute the rest of their business profits as dividends.

Payroll taxes are one of the more efficient taxes the government imposes because they do not burden income used for saving with additional layers of taxation (or higher effective tax rates) compared to income used for immediate consumption, like a pure income tax system would. In general, an efficient tax system only taxes income once, no matter its use.³⁶ Payroll taxes fit this description, hitting wages once, regardless of whether they are used for consumption or saving.

Payroll taxes, like other kinds of labor taxes, also tax human capital, an important component of economic growth. A 2010 Organisation for Economic Co-operation and Development study concluded that countries could improve their tax systems by shifting more of their tax base to consumption and property rather than corporate income or labor income.³⁷ But if we compare the current payroll tax to our traditional income tax system, with its progressive rate schedule and morass of credits and deductions, the current payroll tax is simpler, more transparent, and largely exempts saving and investment, making it less economically damaging overall.

As discussed in the preceding section, few studies have examined the long-run effects of the payroll tax. But for the reasons outlined here, policymakers should be cautious when considering reducing payroll tax rates over other kinds of tax reform, especially given that they would worsen the finances of the trust funds, which are already scheduled to run out by 2033.

Proposed Reforms

Most proposals to alter the US federal payroll tax system have generally focused on increasing trust fund revenues. As it stands, the payroll tax rate would have to increase by 3.82 percentage points to eliminate the chronic deficits in the OASDI trust funds over the next 75 years under current law.³⁸

To avoid a broad payroll tax rate hike, most congressional bills have focused on expanding the payroll tax base by raising the payroll tax cap to make the payroll tax more progressive. Currently, about 7 percent of workers earn income above the taxable maximum, a number that has been stable since the 1990s (Figure 3). Senator Bernie Sanders (I-VT) has proposed applying the payroll tax to earnings above \$250,000,³⁹ while Congressman John Larson (D-CT) has proposed applying it to earnings above \$400,000.⁴⁰

36 William McBride, "How to Judge a Tax Plan," Tax Foundation, Dec. 5, 2011, <https://taxfoundation.org/research/all/federal/how-judge-tax-plan/>.

37 OECD, "Tax Policy and Economic Growth," 2010, https://www.oecd.org/en/publications/tax-policy-reform-and-economic-growth_9789264091085-en.html.

38 Social Security Board of Trustees, "Social Security Board of Trustees: Projection for Combined Trust Funds One Year Sooner than Last Year," Social Security Administration, Jun. 18, 2025, <https://www.ssa.gov/news/en/press/releases/2025-06-18.html>.

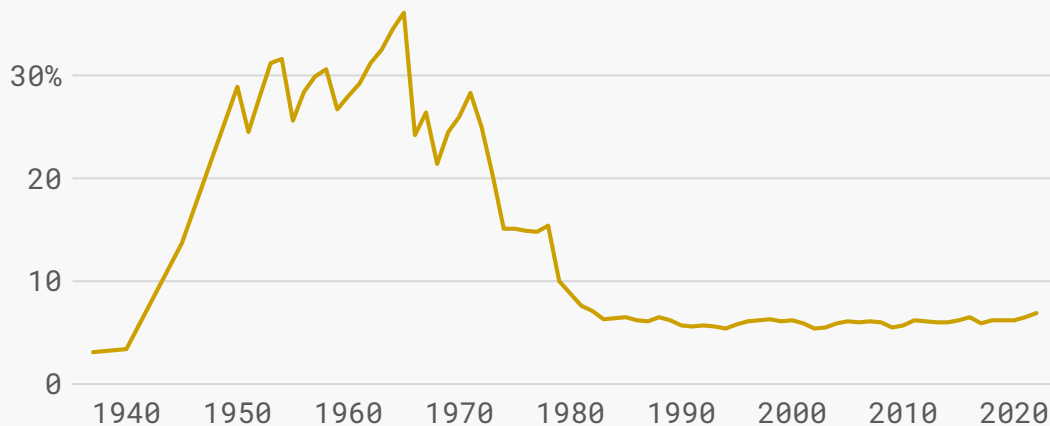
39 S.770 – Social Security Expansion Act, 2025, <https://www.congress.gov/bill/119th-congress/senate-bill/770/text/is>.

40 H.R. 4583 – Social Security 2100 Act, 2024, <https://www.congress.gov/bill/118th-congress/house-bill/4583/text>.

Figure 3.

About 7 Percent of Workers Earn Income Above Taxable Maximum for FICA

Percent of Workers Earning Above Taxable Maximum, 1937-2022



Source: Social Security Administration, *Annual Statistical Supplement 2024*, Table 4.B4; Tax Foundation calculations.



Notably, removing the payroll tax cap entirely and subjecting all earnings above the current taxable maximum of \$184,500 would close approximately a third of the funding gap. Moreover, removing the tax cap would represent a large tax hike for higher earners. Consider a hypothetical taxpayer in New York City who earns \$400,000. Considering federal and state income taxes, this person already faces a marginal rate of 47.9 percent.⁴¹ Removing the payroll tax cap for Social Security contributions would increase this top rate to 60.3 percent. Such a large increase in the top rate would almost certainly have downstream negative economic effects.

Another way to increase payroll tax revenue would be to broaden the base on which the payroll tax is applied, for those who are subject to it. The payroll tax base, though broad, is not as large as it could be because not all forms of compensation face the payroll tax. Over the past several decades, fringe benefits as a share of total compensation have risen significantly, comprising about 17 percent of compensation today, compared to only 7 percent in 1950.⁴² The largest of these is employer-sponsored health insurance (ESI), which is currently exempt from both income and payroll taxation. One estimate finds that subjecting ESI to the payroll tax could reduce Social Security's 75-year shortfall by 25 percent.⁴³

41 Andrey Yushov and Katherine Loughhead, "State Individual Income Taxes Rates and Brackets, 2025" Tax Foundation, Feb. 18, 2025, <https://taxfoundation.org/data/all/state/state-income-tax-rates/>.

42 Alex Durante, "How the Payroll Tax Base Has Changed Over Time," Tax Foundation, Nov. 15, 2024, <https://taxfoundation.org/blog/how-the-payroll-tax-base-has-changed-over-time/>.

43 Karen E. Smith and Richard W. Johnson, "How Much Could Taxing Health Benefits Help Social Security," Center for Retirement Research, 2025, <https://crr.bc.edu/how-much-could-taxing-health-benefits-help-social-security/>.

The Committee for a Responsible Federal Budget has proposed replacing the federal payroll tax with what it calls an Employee Compensation Tax (ECT).⁴⁴ The ECT would apply a 15.3 percent rate to all wages and fringe benefits, including ESI, retirement contributions, stock options, workers' compensation, and commuter benefits. The Urban Institute estimated that the ECT would close nearly two-thirds of Social Security's 75-year solvency gap. Alternatively, the ECT could close nearly one-third of the gap if the remaining revenue were used instead to finance a 1 percentage point reduction in the overall payroll tax rate.⁴⁵

Ultimately, policymakers will have to choose some blend of revenue increases and expenditure cuts to put Social Security back on stable ground. They will have to calibrate that mix carefully to minimize the economic harm from any tax increases.

Conclusion

Congress has not been especially motivated to address the looming entitlement crisis due to the political risks involved. However, if Congress continues to do nothing, then the OASI trust fund will be depleted by the end of 2032, and Social Security benefits will be cut by 23 percent under current law. The Medicare trust fund will suffer a similar fate, facing 11 percent cuts to scheduled benefits. To navigate these significant challenges, policymakers need to understand how the payroll tax works, who pays it, and its impact on the economy.

44 Committee for a Responsible Federal Budget, "An Employment Compensation Tax for Social Security and Medicare," 2025, <https://www.crfb.org/papers/employer-compensation-tax-social-security-and-medicare>.

45 Ibid.