CAMPAIGN FOR WORKING AMERICA

A Real Tax Cut for Working Americans: Repealing and Replacing the Payroll Tax

BEN RITZ AND LAURA DUFFY
PROGRESSIVE POLICY INSTITUTE

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ABOUT PPI'S CAMPAIGN FOR WORKING AMERICA

The Progressive Policy Institute launched its Campaign for Working America in February 2024. Its mission is to develop and test new themes, ideas, and policy proposals that can help Democrats and other center-left leaders make a new economic offer to working Americans, find common ground on polarizing cultural issues like immigration, crime, and education, and rally public support for defending freedom and democracy in a dangerous world. Acting as Senior Adviser to the Campaign is former U.S. Representative Tim Ryan, who represented northeast Ohio in Congress from 2003 to 2023.

Since 2016, Democrats have suffered severe erosion among non-college white voters and lately have been losing support from Black, Hispanic, and Asian working-class voters as well. Since these voters account for about three-quarters of registered voters, basic electoral math dictates that the party will have to do better with them to restore its competitiveness outside metro centers and build lasting governing majorities. The party's history and legacy point in the same direction: Democrats do best when they champion the economic aspirations and moral outlook of ordinary working Americans.

To help them relocate this political north star and to inform our work on policy innovation, PPI has commissioned a series of YouGov polls on the beliefs and political attitudes of non-college voters, with a particular focus on the battleground states that have decided the outcome of recent national elections.

This report is the sixth in a series of Campaign Blueprints that can help Democrats reconnect with the working-class voters who have historically been the party's mainstay.

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INTRODUCTION

Regardless of who wins in November, the next president and Congress will have to rewrite our nation's tax code. At the end of 2025, the individual tax provisions in the Tax Cuts and Jobs Act (TCJA) enacted by Republicans in the first year of Donald Trump's first term will expire. Simply extending all the expiring provisions would saddle future generations with at least $4.6 trillion in debt over the next ten years, with nearly half of the benefit going to the top 5% of households.[1, 2] Working Americans will pay the price for any unfunded extension of these tax cuts, whether it is through higher inflation today or higher taxes needed to fund larger interest payments on the ballooning national debt down the road.

Donald Trump seems to be hoping that working Americans will give him a second term and overlook the costs of extending his 2017 tax cuts by sweetening the pot with additional tax cuts that sound better targeted toward their interests, such as by exempting tips and overtime pay from taxation. But while working-class Americans disproportionately work jobs with hourly wages that are supplemented by tips and overtime pay, many have income tax liabilities that are too low to significantly benefit from such a tax cut.[3] Meanwhile, many working Americans who don't earn tip income or overtime pay would end up facing higher tax burdens than higher-earning workers who do, such as service workers at high-end establishments.[4]

Trump has also proposed income tax cuts for high-income Social Security beneficiaries that would do nothing for working families other than hasten the insolvency of the program and put their benefits in greater jeopardy.[5] The hole will be even deeper because Trump has also called for repealing one of the few TCJA provisions that actually raised revenue — a $10,000 limit on the amount of state and local taxes that itemizers can deduct from their federal taxes, which would effectively result in a $1.2 trillion transfer from working families and future generations to the highest-income households.[6] Altogether, the pandering grab bag of Trump Tax Cuts 2.0 would more than double the cost of extending the original.[7, 8, 9, 10]

But Trump's "plan" to pay for all this by imposing staggeringly high tariffs of 10% to 20% on all imports and up to 60% on goods from China is potentially his worst idea so far. Tariffs are largely passed through to consumers, so Trump's tariff plan would raise the prices of everyday goods bought disproportionately by working families.[11] It would also cause far greater economic harm by raising input prices for domestic industries, weakening the market for American exports, inviting retaliatory tariffs from other countries, and redirecting investment away from heavily impacted industries such that it would destroy far more jobs than it creates.[12] Plus, the declines in both trade and household incomes that Trump's tariff would cause mean that his idea would come nowhere close to paying for all of his other tax cuts, leaving current and future generations of working families to foot the bill.[13, 14]

Instead of expanding TCJA's regressive and costly tax provisions, PPI proposes what would actually be the biggest tax cut on working Americans' wages in history: repealing the regressive payroll tax. Unlike Donald Trump, who would add the cost of his unaffordable and inflationary tax cuts to the national debt, PPI proposes to more than make up for the lost revenue by adopting a progressive consumption tax. This transformational shift in the tax code would slash taxes for the vast majority of American workers, particularly the 123 million lower- and middle-income households who pay more in payroll taxes than in income taxes, while also reducing the deficit.[15] Our approach would put working families first with a tax code that is both more progressive and more pro-growth.

HOW THE PAYROLL TAX WORKS

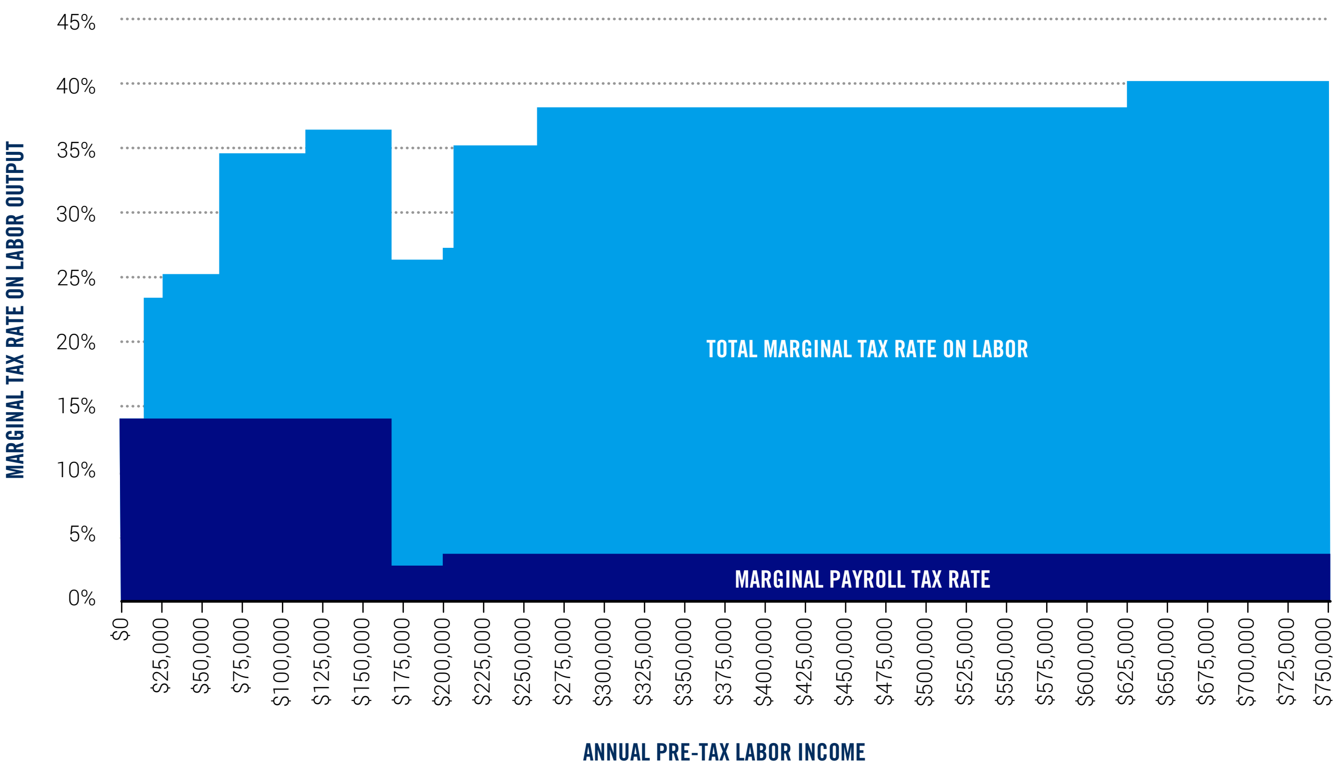
The current payroll tax system in the United States dates back to 1937, when Congress instituted a 2% tax on the first $3,000 of wage income ($66,453 in 2024 dollars) to pay for the newly created Social Security program.[16, 17, 18] Over the past 87 years, the payroll tax has greatly expanded in both its base and rate to become a major burden on American workers. Last year, payroll taxes made up just under a third of federal revenue, but accounted for over 95% of the net revenues raised from workers who earned less than $80,000 that year.[19, 20]

Over two thirds of this payroll tax revenue comes from the Old-Age, Survivors, and Disability Insurance (OASDI) tax, which in 2024 applies a flat 12.4% rate on the first $168,600 of labor income. This tax is split evenly between employers and employees, with the full responsibility falling on self-employed workers. The second major source of payroll tax revenue is the Medicare Hospital Insurance payroll tax, which is set at 2.9% on all labor income (split again between employers and employees). Since 2013, high-earners have paid an additional 0.9% payroll tax on wages above a certain threshold ($200,000 for single people and $250,000 for married couples filing jointly).[21, 22]

WHY REPEALING THE PAYROLL TAX WOULD HELP WORKERS

The current payroll tax system severely undermines the progressivity of the income tax code. The Social Security and Medicare payroll taxes combined impose a 15.3% marginal tax rate on every additional dollar earned by the bottom 94% of workers. By contrast, the top 6% of earners who are above the OASDI tax cap have to pay just 2.9% to 3.8% more in payroll taxes on additional labor income. When combined with the normal income tax rates, this means that a single, full-time worker making the median wage has a roughly equivalent or higher marginal tax rate on additional labor as an individual making four times as much **(Figure 1)**. Thus, repealing the payroll tax would disproportionately help lower- and middle-income American families and dramatically improve the fairness of the American tax code.

FIGURE 1: CURRENT EFFECTIVE MARGINAL TAX RATE ON LABOR OUTPUT



Note: Calculations include payroll taxes and income taxes and assume the earner is a single filer who takes the standard deduction. Marginal tax rates are calculated based on an employee's marginal economic output. For example, an employee whose marginal output is $21.53 per hour faces a $1.53 employer-side payroll tax that is taken out before they receive a $20 hourly wage, which is then subject to a $1.53 employee-side payroll tax. This results in a payroll tax that imposes a 15.3% marginal tax rate when measured as a percentage of the employee's hourly wage but a 14.2% tax when measured as a percentage of their marginal output.

Sources: Internal Revenue Service[23, 24] and PPI calculations.

Even though half of the payroll tax is nominally paid by the employer, the vast majority of the employer-side payroll tax is paid by employees in the form of lower wages. When a business considers hiring a new employee, the amount it's willing to pay to do so is limited by the value the additional employee will produce for that company. Subjecting the business to an employer-side payroll tax cuts into the budget available to pay employees. The business may be able to temporarily shoulder some of the cost by losing some profits, but it will also be less willing to pay as much to hire a new employee.[25] In the long run, employers pass most of the impact of employment taxes along to their workers in the form of lower wages, significantly cutting into the returns families get from their hard work.[26, 27, 28] Provided there's enough competition between businesses for hiring the best employees, removing the employer-side tax on wages would allow businesses to pass the savings on to workers by boosting their wages.

Increasing the take-home pay of working families by repealing the payroll tax would not just help them personally, it would also benefit our economy at large. Like anything that reduces after-tax labor income, payroll taxes make working an extra hour less attractive relative to spending time on unpaid activities. As a result, some individuals will work less on the margin than they otherwise would if they were subject to lower taxes, reducing both their incomes and the supply of labor for the U.S. economy overall.[29] Repealing the 15.3% payroll tax rate would remove the largest tax disincentive most individuals currently face to work. Boosting people's labor incentives would benefit not just individual families, but the nation as a whole, because there would be more workers to fill open jobs and drive the innovations that grow our economy.[30]

WHY A VALUE-ADDED TAX IS BETTER FOR AMERICAN FAMILIES

Repealing the payroll tax would be a clear boon for working families and our economy, but doing so in isolation would leave a $20 trillion-sized hole in the federal budget over the next decade — equivalent to nearly doubling projected deficits.[31] To make up for this gap, PPI proposes that lawmakers should shift towards taxing consumption. Economists generally favor consumption taxes because they do not impose greater tax rates on saving for the future relative to spending money now, so people are not dissuaded from investing in growing the economy. Consumption taxes with a broad base also enable the government to impose lower tax rates on most workers while raising the same amount of revenue that another less-efficient tax would.

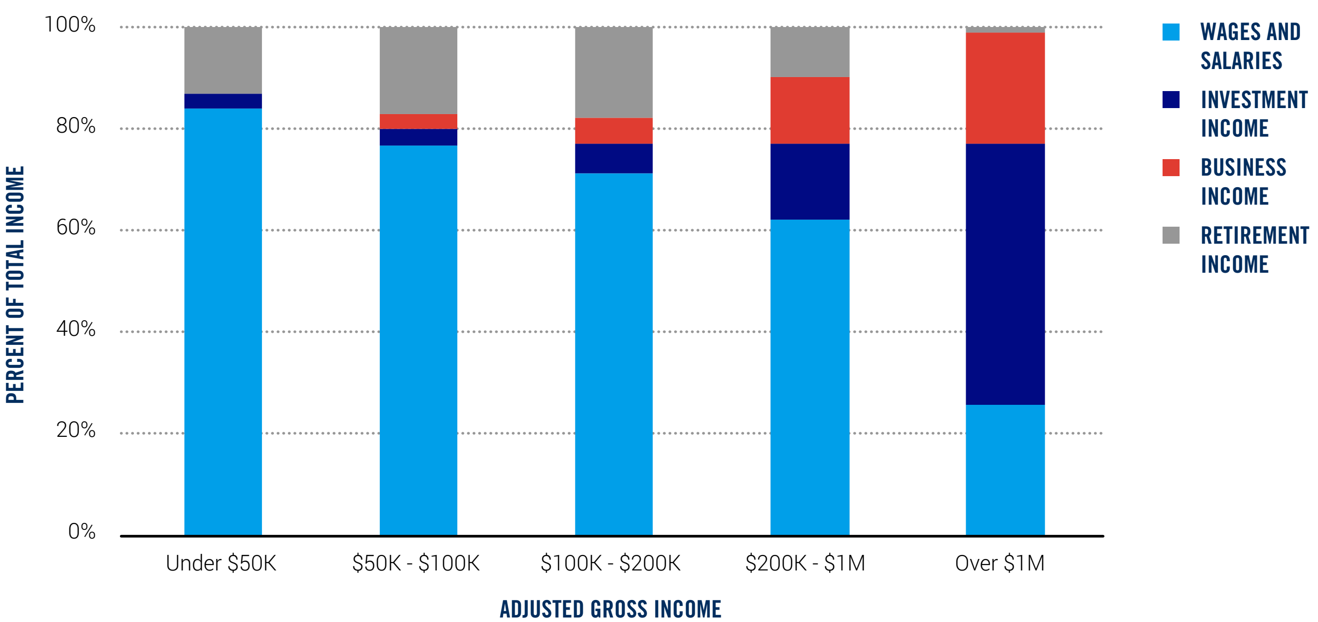
Over 170 countries and all 37 of the United States' peer countries in the Organization for Economic Cooperation and Development (OECD) fund their public programs through a consumption tax known as a value-added tax (VAT).[32] A VAT is somewhat like a sales tax, except that it's collected incrementally at each step in a product's supply chain. When a producer sells a good, it has to pay the tax on the difference between the sales price and the price they paid for the inputs used to make it plus the VAT that was already collected on those inputs.[33]

For instance, suppose that to produce a bicycle, a bike manufacturer currently buys $200 worth of raw materials and sells the final bicycle to a sporting goods store for $300. The sporting goods store then sells the bike to a consumer for $450. In this process, the raw materials supplier, the bicycle manufacturer, and the sporting goods store add $200, $100, and $150, respectively, to the value of the bicycle. If a 10% VAT is imposed, the supplier of raw materials will have to pay $20 in taxes, the bicycle manufacturer pays $10, and the sporting goods store pays $15 in value-added tax, amounting to $45 in VAT revenue total.

When businesses pay the VAT, part of the tax burden falls on certain forms of investment income and wealth that currently escape the payroll tax. Using the example above, say the bicycle manufacturer uses specialized equipment to make a bicycle out of the raw materials it purchases. If that equipment was purchased before the VAT is imposed, then all the value the machine adds to the final bicycle sold would be taxed, which demonstrates that a VAT most aggressively taxes the returns to "old capital" investments that accrue to business owners and investors.[34] A VAT also taxes the future returns to new investments, but because the cost of new investments can be immediately deducted from the business's VAT liability, entrepreneurs still have an incentive to make investments that grow their businesses and create jobs.[35]

The remainder of the VAT burden that does not fall on business and investment income would be borne by households who earn their income through labor — but even still, a VAT would make the tax code much fairer for working families. Higher-income households get a disproportionate amount of their incomes from accrued wealth and business investment that would now be subject to a VAT **(Figure 2)**.[36, 37] By contrast, lower- and middle-income families are more likely to have to work for a living and have all their incomes subject to the payroll tax. As such, by broadening the taxable base to include all forms of income earned by households, a VAT would end up taxing households across the income distribution roughly equally over their lifetimes.[38, 39]

FIGURE 2: SOURCES OF INCOME BY ADJUSTED GROSS INCOME



Note: Sources of income data are for the most recent year available (2021).

Source: Tax Foundation.[40]

This broader and more equally distributed base allows the federal government to tax working families at a lower rate while still raising the same amount of revenue. For example, PPI estimates that a VAT applied to all goods except government-provided healthcare, education spending, and services provided by charities could raise roughly the same amount of revenue with a 12.5% rate that the current payroll tax does with a rate of 15.3% on most earnings.[41, 42] The vast majority of employees whose income falls below the current OASDI tax cap would receive a tax cut of up to $5 on each $100 they earn and consume if the current payroll tax were replaced with a VAT that raised the same amount of revenue.[43, 44, 45]

With all effects considered, analyses show that the average household in every income decile except the top 10% of earners would benefit if a revenue-neutral VAT partially or wholly replaced the payroll tax.[46] As such, even though economists are uncertain whether implementing a revenue-neutral value-added tax would cause a one-time increase in the price level, working families' purchasing power would rise by more than enough to offset any increase in prices due to their facing a lower tax burden on net.[47, 48] For instance, PPI estimates the median married couple would see its real after-tax income rise by up to $7,000 per year relative to the current payroll-tax system.[49, 50, 51]

Those households in the 90-95th percentile range would break even on average, and the average household in the top 5% would see an increase in taxes. But unlike other proposals to tax the rich, such as by greatly hiking corporate or investment income taxes, a VAT's exemption for capital spending would limit its impact on incentives to save and invest.[52] This would thereby greatly increase the progressivity of the tax code, but without significantly harming economic growth.

IMPROVING TAX PROGRESSIVITY

Although the switch from taxing payrolls to taxing consumption would be good for the vast majority of working families, there would be some years in which low-income and unemployed workers whose spending nearly equals or exceeds their earnings bear a disproportionate burden if no other changes are made to the tax system.[53, 54] Some states and countries with sales taxes or VATs respond to this challenge by exempting goods disproportionately purchased by low-income families (such as groceries) from taxation. But doing so can distort economic incentives, as two households with the same incomes would face a different tax burden if they consume more or less of the exempted goods.

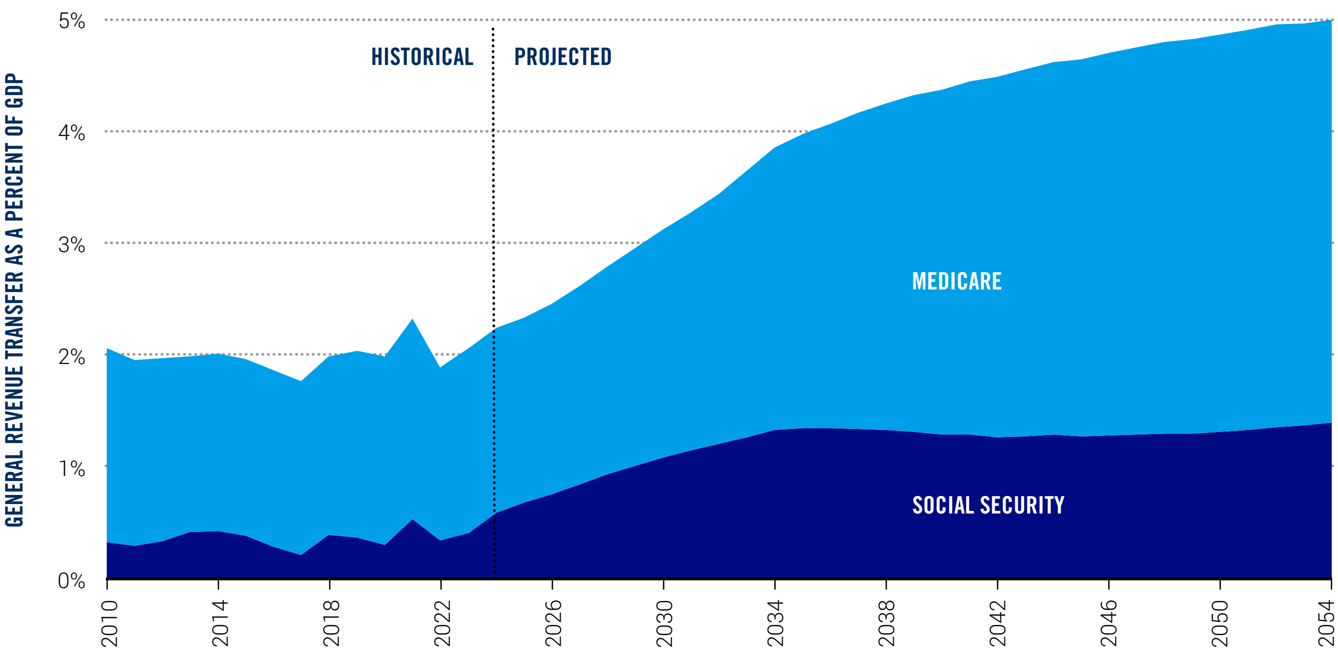
A better way to insulate very low-income households from the effects of a VAT — and further improve the tax code's progressivity — would be to rebate some of the revenue to households.[55] For example, lawmakers could modify existing refundable tax credits, such as making the Child Tax Credit fully refundable and indexed for inflation or expanding the Earned Income Tax Credit, to better ensure very low-income families are kept whole in the transition to a VAT system. Automatic cost-of-living adjustments for existing social programs would also prevent their value from being eroded by any costs associated with the enactment of a VAT, further protecting low-income families.

Covering these additional costs would require adopting a higher VAT rate than that which would be required to merely offset the loss of payroll tax revenue.[56] But if policymakers adopted a VAT set at the current payroll tax rate alongside our other proposed reforms, they could raise more than $3 trillion of additional revenue over the next 10 years — roughly half the savings needed to prevent the national debt from growing faster than our economy. And because part of the VAT falls on investment and wealth, this proposal would still reduce the tax burden for most working Americans relative to raising the same revenue through a higher payroll tax.[57]

FINANCING SOCIAL SECURITY AND MEDICARE WITHOUT THE PAYROLL TAX

Perhaps the biggest political and practical obstacle to repealing the payroll tax is the role it plays in financing and determining benefits for Social Security and Medicare. Historically, the payroll tax served an important political purpose by establishing that these were earned-benefit programs by creating a link between a worker's lifetime contributions and the benefits they drew upon in retirement. But in truth, both programs have been spending more on benefits than they collect in payroll tax revenue for many years now, and the gap between revenue and benefits is only growing **(Figure 3)**. By the time all the programs' trust funds that enable them to run annual deficits are projected to be exhausted (roughly a decade from now), revenue from payroll taxes and other dedicated sources will cover less than 80% of Social Security and 90% of Medicare Hospital Insurance (or about half of total Medicare spending).[58]

FIGURE 3: GENERAL REVENUE TRANSFERS TO MEDICARE AND SOCIAL SECURITY



Note: Projections assume benefits continue to be paid as currently scheduled, even after the associated trust funds are exhausted.

Sources: Congressional Budget Office,[59, 60] Medicare Trustees,[61] and PPI calculations.

Many popular proposals to shore up the programs would either further strain the link between contributions and benefits or impose an even greater burden on working Americans. For example, eliminating the OASDI payroll tax cap and taxing all income above $168,600 at the full 12.4% rate — while providing no additional benefits to those who are now making substantially increased contributions — would only close about half of Social Security's financing gap even as it constrains lawmakers' ability to raise taxes on high-income households to fund other policy priorities.[62] Alternatively, simply raising the payroll tax rate would make working Americans foot the entire bill for beneficiaries who did not contribute enough to finance the program during their working lives.

Since Social Security is already dependent on general revenues to pay its bills, there is no point in retaining a regressive and anti-growth tax when it can't even serve the purpose for which it was created. PPI's recent "Paying for Progress" report offers policymakers a new framework for calculating Social Security benefits based on how many years an individual worked rather than how much they earned.[63] This approach would both be more progressive than the current benefit formula and cement a stronger link between work and benefits earned without the need to rely on payroll-tax contribution histories to calculate benefits. Medicare, meanwhile, already receives most of its revenue from sources besides payroll taxes and premiums. But the program remains politically popular, demonstrating that the payroll tax is unnecessary as a financing mechanism if it is not being used for determining benefit levels.

Policymakers would have a number of options available for financing Social Security and Medicare without relying on payroll taxes. Congress could retain the use of trust fund accounting by earmarking a different revenue source to replace the lost payroll tax revenue. Alternatively, policymakers could replace the trust funds with a global budget that lets them dictate program spending instead of relying on payroll tax revenue to determine what resources are available to pay benefits. As long as the program stays on a sustainable fiscal trajectory, the existence of this separate budget would remove Social Security and Medicare from the annual budget process and protect it from cuts, just as the trust funds currently do.

CONCLUSION

The current payroll tax is a substantial burden on most American workers. It suppresses wages, dampens economic growth by cutting into returns to work, and severely undermines the progressivity of the income tax code. Yet despite these shortcomings, the payroll tax doesn't even raise enough revenue to fund the programs it was designed to fund. Our country is aging, so continuing to rely on the payroll tax to pay for expanding benefits to older Americans would be either insufficient to fund our government and/or require placing additional burdens on younger workers.

Consumption spending, by contrast, has remained roughly constant as a share of our economy over the past few decades, and is more spread out over one's lifetime than is labor income. Taxing consumption would also spread the burden of taxation from labor to profits and previously accumulated wealth, thus dramatically improving the progressivity of the tax code. In turn, working families could see their wages increase and taxes cut by thousands of dollars per year while the federal government's annual budget deficit is reduced by up to $300 billion. For these reasons, taxing consumption instead of payrolls would both grow our economy and improve the lives of working Americans.

ABOUT THE CENTER FOR FUNDING AMERICA'S FUTURE

Launched in 2018, the Progressive Policy Institute's Center for Funding America's Future works to promote a fiscally responsible public investment agenda that fosters robust and inclusive economic growth. To that end, the Center develops fiscally responsible policy proposals to strengthen public investments in the foundation of our economy, modernize health and retirement programs to reflect an aging society, transform our tax code to reward work over wealth, and put the national debt on a downward trajectory.

ABOUT THE AUTHORS

Ben Ritz is the Vice President of Policy Development for the Progressive Policy Institute. In this capacity, he helps PPI's policy experts develop analysis and "radically pragmatic" ideas consistent with the organization's mission of supporting innovation, economic opportunity, and the enduring values of liberal democracy. Ben's expert analysis has been published in the Washington Post, the New York Times, the Wall Street Journal, Forbes, and other national news outlets. Ben also serves as the Director of PPI's Center for Funding America's Future.

Prior to joining PPI, Ben staffed the Bipartisan Policy Center's Commission on Retirement Security and Personal Savings and served as Legislative Outreach Director for The Concord Coalition. Ben earned his Master's of Public Policy Analysis; a Graduate Certificate of Public Finance; and a BA in Communication, Legal Institutions, Economics, and Government from American University.

Laura Duffy is a Policy Analyst with PPI's Center for Funding America's Future. Prior to joining PPI, Laura was the Executive Research Coordinator at Rethink Priorities and a Community Organizer for Forward Montana in her hometown of Great Falls. She also served on the steering committee for the Center for New Liberalism, a grassroots organization that advocates for center-left policies that will create a more open and prosperous society. Laura graduated from the University of Chicago with a Bachelor of Science in Statistics.

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PROGRESSIVE POLICY INSTITUTE
1919 M Street NW,
Suite 300,
Washington, DC 20036

Tel 202.525.3926
Fax 202.525.3941

info@ppionline.org
progressivepolicy.org