The Impact of the FICA Payroll Tax on Two-Parent Families with Children

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Introduction

Child tax credits, the EITC (Earned Income Tax Credit), and TANF (Temporary Assistance for Needy Families) have been analyzed extensively for their impacts on families with children. However, we turn our attention to the FICA (Federal Income Contribution Act) tax which is a federal payroll tax imposed on employers and employees in order to fund Social Security and Medicare. Although the FICA tax is not thought of as a child-related policy variable, its impacts can be large enough to counter the benefits of other child-centered policies such as the Child Tax Credit. In this project, we explore the effects of FICA taxes on two-parent families with children.

We focus on two ways that the FICA tax can affect two-parent families with children, especially those families with low income-to-needs ratios (the ratio of total family income to the poverty level). The first is the direct loss of income from total family FICA tax payments. The second is the indirect effect from altered labor supply and earnings caused by the FICA taxes. For our study we focus mainly on the labor supply of wives. As a result of lower wage rates, higher reservation wages, and larger income effects often facing wives in two-parent families, the FICA tax effects are expected to be particularly strong determinants of labor supply decisions for this group.

Data

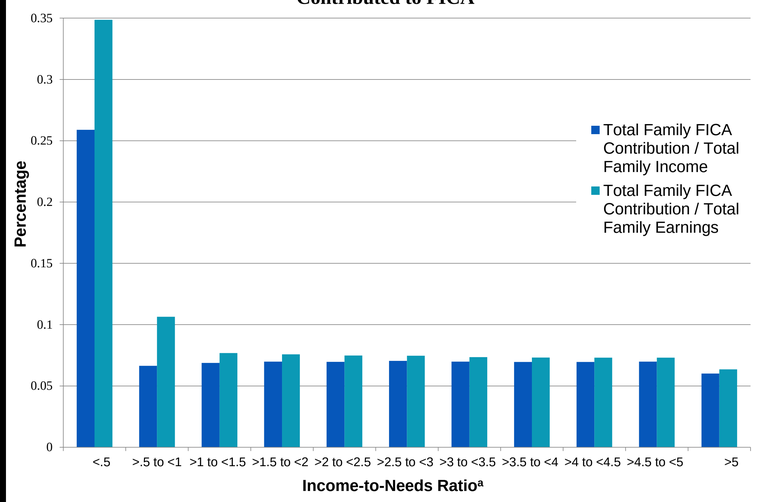
This study uses data from the Annual Social and Economic Supplement (ASEC) to the Current Population Survey (CPS) for years 2009-2012. The CPS is a survey of about 100,000 households aimed at providing statistics about socioeconomic factors and labor force estimates. All the income data provided in the ASEC are from the previous year. Therefore our sample deals with income data collected from 2008-2011. The data have a hierarchical structure and have three levels – household, family, and person.

For our analysis, we focus on the family unit defined by the CPS as "a group of two people or more (one of whom is the householder) related by birth, marriage, or adoption and residing together". This definition does not include foster children. For this reason, we omit them from our analysis. We restrict our sample even more to two-parent families with children.

Direct Loss: Regressivity of the FICA Tax

Without taking into account lifetime benefits and taxes, the FICA payroll tax is regressive because of the constant tax rate and cap on taxable earnings. Therefore it is hitting families with low income-to-needs ratios harder than it is hitting families with high income-to-needs ratios.

Average Percentage of Two-Parent Family Income and Earnings Contributed to FICA



* All means are calculated using the March Supplement Weight to weight all observations.
[a] Income-to-Needs ratios are based off the Official Poverty Threshold.

- The FICA tax represents a large percentage of earnings and income for low-income, two-parent families.
- It can account for up to 35% of a family's earnings and up to 26% of a family's income. In comparison, high-income families contribute only about 6% to 7% of their income and earnings to FICA.

Indirect Loss: Effect on the Labor Supply

Model:

- We ran a pooled OLS regression because the CPS does not survey the same families every year. We also did a Tobit regression because the dependent variable (annual hours worked) is left-censored.

$$H_{i,t} = \beta_0 + \beta_1 W_{i,t}(1 - T_t) + \beta_2 C_t + \beta_5 Y_{i,t} + \beta_6 FamilyFICA + \beta_7 Children + \varepsilon_{i,t}$$

where:

$H_{i,t}$ = Annual hours worked for a woman i in year t.
T_t = The FICA tax rate in year t.
$W_{i,t}$ = The hourly wage rate for a woman i in year t.
C_t = The cap on FICA taxable earnings (in thousands of dollars).
$Y_{i,t}$ = Non-Labor Income for a woman i in year t (in thousands of dollars).
$FamilyFICA$ = Total FICA contributions of other family members.
$Children$ = Number of children.
$\varepsilon_{i,t}$ = Randomly distributed error term.

- We then ran a log-log OLS model and a log-log Tobit model to look at the percent changes.
- Because of negative values we did not take the log of non-labor income.
- For $H_{i,t}$, $W_{i,t}$, and $FamilyFICA$, there are many zero values. We changed the observations that were 0 to .5 in order to take the log.
- Our sample is restricted to married women who have children, have no self-employment or farm earnings, and are not ill, disabled, or retired.

Results

	(1) OLS	(2) Tobit	(3) Log-Log OLS	(4) Log-Log Tobit
$W_{i,t}(1-T_t)$	3.763**	5.342**		
	(1.253)	(1.723)		
C_t	-8.847***	-12.16***		
	(1.913)	(2.595)		
$Y_{i,t}$	-2.954***	-3.205**	-0.00509***	-0.00718***
	(0.735)	(1.022)	(0.000514)	(0.000746)
$FamilyFICA$	-0.0246***	-0.0347***		
	(0.00153)	(0.00227)		
$Children$	-189.0***	-273.3***	-0.0575***	-0.0951***
	(4.632)	(6.899)	(0.00300)	(0.00492)
log($W_{i,t}$)			3.636***	4.205***
			(0.00584)	(0.00573)
log($W_{i,t}$* T_t)			-3.508***	-4.068***
			(0.0142)	(0.0111)
log(C_t)			-3.257***	-5.096***
			(0.137)	(0.184)
log($FamilyFICA$)			-0.0117***	-0.0155***
			(0.00110)	(0.00149)
_cons	2580.7***	2923.2***	14.82***	22.27***
	(201.9)	(273.5)	(0.637)	(0.858)
N	71320	71320	71320	71320
R-sq	0.069		0.967	
adj. R-sq	0.069		0.967	
pseudo R-sq		0.006		0.616

Robust standard errors in parentheses, **p<.01 *** p<.001
All regressions are done using the March Supplement Weight.

Discussion and Future Research

From the regression results, we can see that the FICA tax has a negative impact on annual hours worked for married women with children. According to the third model, a 1 percent increase in the taxed portion of the wage, T*W, lowers annual hours by 3.5 percent. An increase of 1 percent in the cap on taxable earnings reduces annual hours further, by 3.3 percent. An additional negative impact comes from the FICA payments of other family members. Together, these estimates suggest a significant reduction in annual hours and earnings. If we combine these indirect impacts with the direct effects described above, we see that the FICA tax has the potential to push more children into poverty.

As a next step, we will use our estimates to simulate the impact of the 2013 FICA tax increase on child poverty rates and the depth of child poverty. We will also compare the FICA tax to the Child Tax Credit and explore the extent to which the FICA tax offsets this child-targeted income support.

Acknowledgements and References

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