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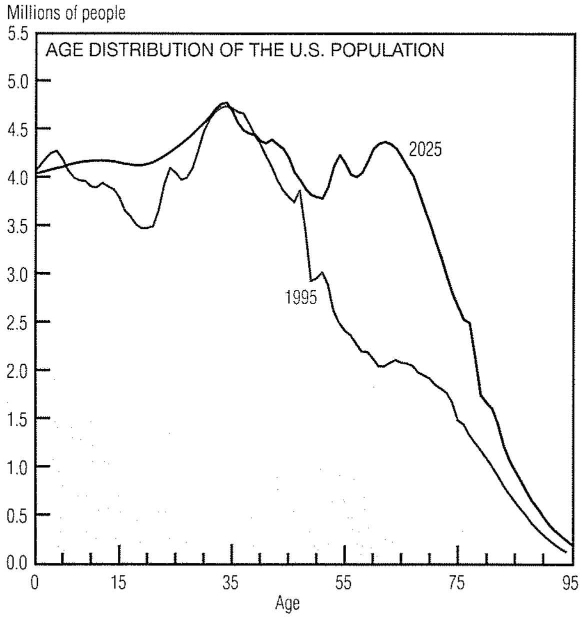
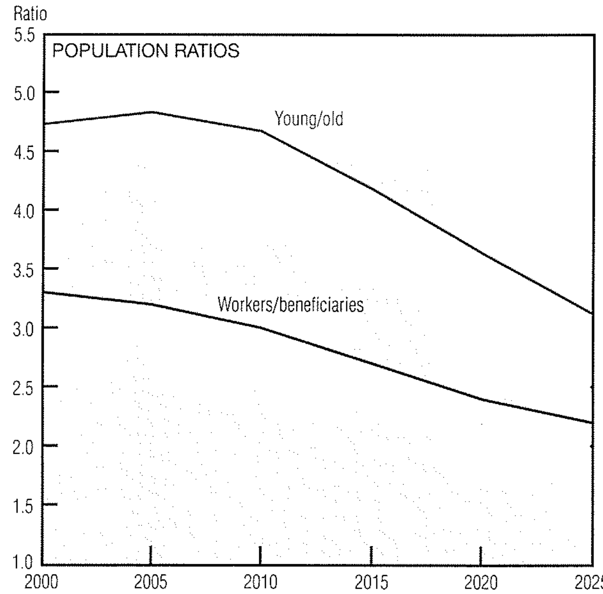
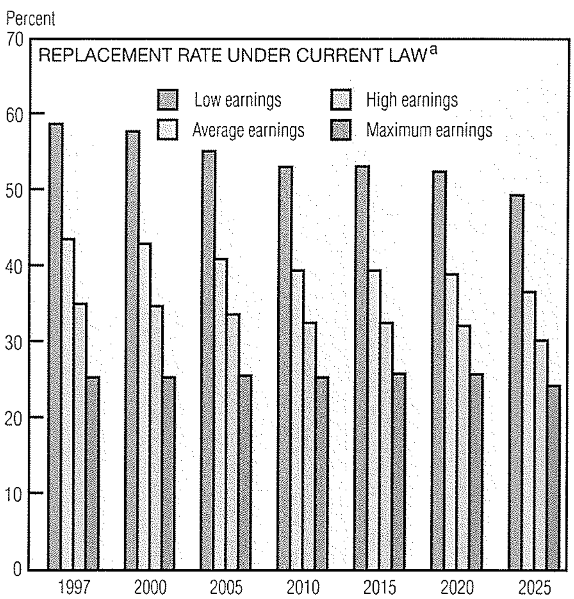
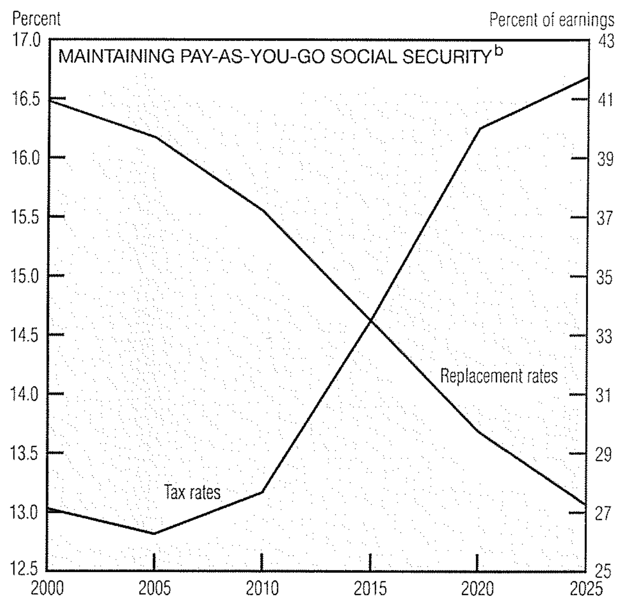
Social Security—A Problem









a. Percent of annual earnings replaced by Social Security benefits.
b. Indicates the tax rates or benefit reductions required to maintain pay-as-you-go Social Security.
SOURCE: 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C., April 24, 1997.

Demographic projections indicate that the number of elderly retirees will grow sharply by 2025, but the number of young, working-age individuals will increase only slightly. This implies a steep decline in the ratio of contributing workers to retired beneficiaries in the Social Security system—from 3.3 today to 2.2 by 2025. Such a sharp swing in the proportion of workers to beneficiaries will devastate a pay-as-you-go system in which workers' contributions are immediately and directly transferred to retirees as benefits.

When we have fewer workers per beneficiary, we will need either a tax increase or a benefit cut to preserve the solvency of pay-as-you-go Social Security. With 3.3 workers per beneficiary, a payroll tax rate of 12.4% produces enough annual revenue to replace 41% of annual earnings with retirement benefits. If the ratio falls to 2.2, a 12.4% tax rate would replace only 27.3% of annual earnings. Maintaining the replacement rate at 41% would require a payroll tax rate of 18.6%—1.5 times the present rate.

Under current rules, the replacement rate is already projected to decline for all income groups. For individuals with average earnings, it will fall from 44% today to about 37% by 2025. Thus, to preserve benefit levels under the pay-as-you-go structure of Social Security, payroll tax rates must gradually rise to about 16.7% by that year. Payroll tax rates would have to increase 2.2 percentage points now to maintain the system's long-term solvency.