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.