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The Social Security Notch Issue

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Committee on Ways and Means
House of Representatives

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THE SOCIAL SECURITY NOTCH ISSUE

SUMMARY OF STATEMENT BY JOSEPH F. DELFICO
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In response to the continuing controversy surrounding the Social Security "notch" issue, the Chairman of the Subcommittee on Social Security, House Committee on Ways and Means, asked the GAO to conduct an independent study. GAO studied: how the notch arose; how beneficiaries are affected; alternatives for financing legislation to address the problem; and socioeconomic characteristics of the notch group.

GAO found that benefit differences arose between closely adjacent retiree groups subsequent to the Congress' actions, in the 1977 Amendments to the Social Security Act, to correct a problem with the benefit formula that was leading to much higher benefit awards than expected. The differences arose primarily from

-- new benefit rules that reflected the intent to lower replacement rates by 5-10 percent.

-- the separation by birthdate of those who continued to use the old benefit formula and those who came under the new formula.

-- higher than expect inflation subsequent to the implementation of the new formula.

While dollar disparities are small for those retiring at age 62, they can be sizable for individuals who retire at later ages and who are high lifetime earners. Even so, replacement rates for the notch group are often higher than many of those coming before and after them. Those in the notch group compare their benefits to a group that benefited from an overgenerous formula.

Legislation to address the problem by awarding higher benefits to the notch group is costly and would affect both the short-run and long run status of the trust fund. Alternative financing mechanisms for notch legislation require the Congress to reassess important past decisions. GAO does not support any specific notch legislation but suggests that the Congress,

-- keep the effect of notch legislation on current and projected trust fund balances as neutral as possible.

-- evaluate the resources and time required for implementing legislation.

-- retain the current transition period.

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the results of our study of the social security notch issue.[1] This issue has been a concern of your subcommittee, and the Congress, for the past nine years, and of many of the nation's elderly who feel that they have not been treated fairly by the Social Security system.

WHY THE NOTCH OCCURRED

The "notch" refers to differences in the benefits received by individuals with similar work histories who first became eligible for social security benefits just before or just after January 1, 1979, the date upon which a new set of social security benefit computation rules became effective. In general, individuals born in 1916 (who turned 62 during 1978) were covered by the old rules and received higher benefits than individuals with similar earnings histories who were born in 1917, (who turned 62 during 1979) and were covered by the new rules.

To understand how these benefit differences arose, it is necessary to review the broader pattern of changes occuring over the last fifteen years in the social security benefit

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1 Social Security: The Notch Issue, GAO/HRD-88-62, March 1988.

computation rules. The chart attached to my statement shows the actual history of, and current projections for, replacement rates under social security. These rates are for illustrative workers retiring at age 65, in successive years over the period 1965 to 2010. In this chart, the replacement rate is defined as the age 65 retiree's benefit divided by his or her wages at age 64. The individuals shown are those who retired at age 65 after having always earned a wage equal to the average under social security.

The chart shows that replacement rates were relatively stable in the late 1960s. In the early 1970s, however, they began to rise, meaning that the initial benefit awarded to age 65 retirees was increasing at a faster rate than was the preretirement earnings of the age 65 retirees. The increase in replacement rates prior to 1973 was intended; in 1972 the Congress had legislated a 20 percent benefit increase and had provided that social security benefits should be automatically adjusted for changes in the cost of living thereafter. The increase occuring after 1973 was not intended.

Shortly after the Congress instituted automatic adjustments for inflation, it was discovered that the method used to adjust benefits was flawed. Specifically, at the rates of inflation that we began experiencing in the mid 1970s, the adjustment procedure had the effect of over indexing the benefits of future retirees. As a result of this flaw, replacement rates began to rise steadily.

Had the benefit computation rules not been changed and inflation continued, the flaw eventually would have increased social security benefits to a point where an average earner would have received more in retirement from social security than he or she earned before retirement. Clearly the computation rules had to be changed, and these changes were made in the 1977 Social Security Amendments. In changing the rules, however, the Congress had to make several important decisions. Among these were: (1) what replacement rate should be afforded future retirees, and (2) to whom should the new computation rules first apply?

The Congress decided to set the replacement rate for an average earner at about 42%, which was roughly the level prevailing in 1975-76. That decision meant that workers under the new system would receive higher replacement rates than had been afforded similar workers retiring in the late 1960s and early 1970s, but would not get as much as the old rules would produce for workers retiring in 1978 or 1979 (the pre-notch group). Since the new system was to become effective on January 1, 1979, the Congress also had to decide how to calculate the benefits of persons who would be eligible prior to January 1, 1979 (that is, those who were at least 62 years old on that date). The Congress decided that this pre-notch group should be allowed to use the old formula, even if it resulted in their getting higher benefits than similar retirees that came before, or would follow afterwards. In combination with the old, flawed formula, the rapid inflation occuring in the late 1970s and early 1980s caused the benefits of the pre-notch group to rise even faster than had been expected, and thus made the gap between old law and new law benefits even greater.

When it adopted the new benefit computation rules in 1977, the Congress was also concerned that the new rules might cause significant changes in the benefit amounts to be awarded some individual workers who were close to retirement. It adopted a special transition benefit formula for persons reaching age 62 in the first five years after the new system went into effect. That formula provided an alternative computation which could be used to calculate retirement benefits, if use of the alternative resulted in higher benefits.

The first group of age 65 retirees to which the new rules applied retired in 1982; they are the notch group. Workers who had always earned the average wage and retired in that year -- as well as in the next several years -- would have received the transition benefit, rather than the lower replacement rate which was to be afforded to those retiring in the late 1980s and thereafter. In the chart, we see that the replacement rates begin to fall for age 65 retirees after 1981, but they do not fall to the 42 percent level until 1984.

In summary, replacement rates under social security rose steadily through the 1970s, largely as the result of a flaw in the automatic adjustment procedure adopted in 1972. When the Congress fixed the formula in 1977, it decided that future replacement rates would be set at levels which were somewhat higher than had prevailed in the early 1970s, but were lower than the formula would produce for persons retiring in the late 1970s. The notch group is the first group of retirees to have their benefits computed under the new law. They received lower replacement rates than did those who retired just before them, but because of the transition rules, many of them received higher replacement rates than those who will retire after them.

In our view, the 1977 Amendments achieved their purpose of stabilizing future replacement rates. However, controversy still surrounds the differences in benefits between the notch group and others.

CONSIDERATIONS FOR EVALUATING LEGISLATIVE PROPOSALS

Legislation to "correct" the notch has been proposed in many forms and assumes that compensation is warranted. Even so, a policy decision to address the notch must deal with pragmatic and complicated questions of cost, who pays, who benefits, and whether a "solution" is administratively feasible.

Legislative proposals to diminish the notch are costly. The Social Security Administration estimates that additional payments to beneficiaries through 1996 under various proposals could range from about $20 billion to over $300 billion. For the most part, proposals to diminish the notch lack specific financing mechanisms. This implies using current trust fund balances to pay the higher benefits. However, using these balances to finance higher benefits to notch recipients would slow the system's attainment of minimum contingency levels and could put the system at additional risk should we experience an economic downturn in the next few years. Reducing current trust fund balances also adversely affects the system's long run actuarial balance.

Other options for financing notch remedies involve either, increasing revenues through payroll taxation or, reducing other expenditures such as by slowing the growth of benefits for those under the old law. This latter option has merit because retirees under the old law were overcompensated. But it has been considered in the past and rejected. It would require that Congress reassess its decision in 1977 not to affect the benefits of those attaining eligibility before the new law's implementation in 1979.

The option of raising payroll taxes presents additional complications. Because of the 1983 Amendments to the Social Security Act, current workers are paying higher payroll taxes than previous workers who financed the system on a pay-as-you-go basis. Imposing additional taxes on these current workers to finance a higher replacement rate for the notch group (many of which already receive a higher replacement rate than can be anticipated by current workers) raises another significant equity issue.

In our view, the Congress should keep the effect of notch legislation on current and projected trust fund balances as neutral as possible. Given the constraints on alternative financing mechanisms mentioned above, this means that the cost of any notch legislation must be low.

In deciding whether to adopt notch legislation, other factors relating to the matter of "who benefits," should also be considered. Because of social security cost-of-living increases that outpaced wage increases, many notch retirees benefited relative to non-retired groups from the inflation of the 1970s and early 1980s. Thus, while those in the transition may be worse off relative to those born immediately preceding them, in many instances, they gained relative to the current workers who now contribute to pay their benefits.

While the elderly have become better off as a group over time, we recognize that many remain poor. However, notch legislation is not likely to do much to make the poor better off. The pattern of the notch disparity and the data on income and assets we examined, suggests that notch legislation will tend to benefit those who, on average, have higher retirement incomes and greater asset holdings. Furthermore, those who tend to be in poorer health are more likely to have lower lifetime earnings and retire early, and thus experience smaller benefit disparities.

Another matter concerns the length of the transition period. The original five year period provided adequate notice of the change to a new benefit formula. Extending the transition period would draw more individuals into the controversy and could extend higher benefits to those who now come fully under the new law formula. It is our opinion that extension of the transition period is not warranted.

One additional matter the Congress should be concerned about is the implementation of notch legislation. Although we were not asked to focus on this aspect specifically, discussions with SSA staff suggest that implementation of notch remedies might be difficult. Depending on the form of legislation, SSA could be required to perform benefit recomputations for millions of recipients. Practical limitations of the agency's computer software could require that many recomputations be performed by hand. This would place an additional burden on an agency that has already experienced recent staff and resource cuts and could require additional expenditures or reallocation of agency resources. We believe that notch legislation should not be adopted without careful consideration of SSA's ability to efficiently and effectively implement it, and bear the associated administrative costs.

That completes my prepared statement, Mr. Chairman. My colleagues and I would be pleased to respond to your questions.

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