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The Social Security Notch Issue

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THE SOCIAL SECURITY NOTCH ISSUE

SUMMARY OF STATEMENT BY JOSEPH F. DELFICO
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The GAO reviewed the recent report on the Social Security notch issue by the National Academy of Social Insurance, The Social Security Benefit Notch: A Study, November 1988. GAO finds the study to be an excellent, expert analysis of the facts underlying concern about the notch. Furthermore, the study agrees with and confirms the analysis which GAO conducted and reported on in March 1988.

The benefit differences commonly referred to as the "notch" 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. These differences are associated with; (1) new benefit rules that reflected the intent of the Congress to lower and stabilize replacement rates, (2) the separation by birthdate of those who continued to use the old benefit formula and those who came under the new formula and (3) higher than expected 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 lifetime high 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 benefitted from an overgenerous formula.

Legislation to address the benefit differences by awarding higher benefits to the notch group is costly and would affect 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. Also, notch legislation would tend to benefit those who are already better off and, the Social Security Administration may have difficulty in implementing some forms of legislation.

The facts suggest that the argument that the notch represents a major inequity is not compelling. Furthermore, the issue must be viewed in light of the current realities of social security finance and the federal budget. Absent other offsetting adjustments, addressing the notch would increase projected budget deficits and delay the attainment of an adequate level of trust fund contingency reserves.

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the social security notch issue and the recent report of the National Academy of Social Insurance. I share your concerns about the implications of the notch issue for the social security program.

We have reviewed the study of the National Academy and find it to be an excellent, expert analysis that enhances the public record regarding the notch issue. Furthermore, I am pleased to note that the findings of the study agree with and confirm the findings of the lengthy analysis of the notch issue that we reported on last spring.[1]

THE FACTS OF THE NOTCH

The National Academy study should leave little doubt as to the basic facts underlying the notch issue.

The notch refers to differences in benefits received by individuals who have similar work histories and first become eligible for benefits just before or just after January 1, 1979, the date set for implementation of new benefit computation rules.

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1 U.S.General Accounting Office, Social Security: The Notch Issue (GAO/HRD-88-62, Mar. 24, 1988)

The need for new computation rules arose because of a flaw in the benefit computation instituted in 1972 which provided for automatic adjustment for inflation. For many individuals reaching the age of first benefit receipt, benefits in relation to preretirement earnings (replacement rates) began an unintended rise. This resulted from the pattern of wage and price increases experienced after implementation of the indexing procedure. This is shown in the chart attached to my statement. Furthermore, replacement rates for some retirees were projected to rise to unprecedentedly high levels.

A consensus developed to change the benefit rules and these changes were made in the 1977 Amendments. In changing the benefit rules, 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, retiring at age 65, at about 42%, which was roughly the level prevailing in 1975-76. This 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 the 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.

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 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 that could be used to calculate retirement benefits, if use of the alternative resulted in higher benefits.

Not only could the retention of the old benefit formula allow some individuals to receive higher benefits but, an additional feature of this formula resulted in a significant increment in benefit amount from additional years of work past the age of eligibility for benefits (age 62). The new benefit rules and the transitional formula substantially reduced the gain from additional earnings after the age of eligibility.

In combination with the old, flawed formula, the rapid inflation of the late 1970s and early 1980s caused the benefits of the pre-notch group to rise even faster than had been expected, relative to those under the new rules. Furthermore, inflation exacerbated the gap between those who continued to work after age 62 under the old rules compared to those doing the same, but under the new rules.

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 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.

The basic purpose of the benefit formula revision in the 1977 Amendments was to stabilize future replacement rates. In our view, this was achieved.

CONSIDERATIONS IN EVALUATING LEGISLATIVE PROPOSALS

The past several Congresses have seen numerous legislative proposals to "correct" the notch and increase benefits for those under the new rules. We can expect that such proposals will surface again in the 101st Congress. These proposals raise pragmatic and complicated questions of cost, who pays, who benefits and whether a legislative solution could be administratively feasible.

Legislative proposals to address the notch carry substantial cost. The Social Security Administration estimated that additional payments to beneficiaries through 1996 under various proposals introduced in the 100th Congress ranged from about $20 billion to over $300 billion. Additional costs would continue after 1996. For the most part, proposals to diminish the notch lack specific financing mechanisms. This implies using current trust fund balances to pay higher benefits. However, using these balances to finance higher benefits to notch recipients would slow the system's attainment of minimum contingency reserve 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 the advantage of reducing benefits to those retirees who were overcompensated under the old law. 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 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 benefitted relative to non-retired groups from the inflation of the late 1970's 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 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 with which the Congress should be concerned is the implementation of notch legislation. Although we were not asked to focus on this aspect specifically in our March 1988 report, 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 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 implement it efficiently and effectively , and bear the associated administrative costs.

SHOULD ANYTHING BE DONE?

The notch presents the Congress with a difficult policy decision. The benefit disparities can be large, but the facts show that their seriousness depends on the perspective one adopts. Those who argue that the notch is unfair compare the benefits of the notch group to the group of retirees which was the most overcompensated. Alternatively, as our work, and that of the National Academy show, when viewed in a broader historical context, many of those in the transition or notch group fared quite well especially relative to those born before 1910 and after 1921. On balance, an objective examination of the facts suggests that the case for inequity resulting from the 1977 Amendments is not a compelling one.

Finally, the case for the notch must be evaluated in terms of the current realities of social security finance and the federal budget. The agenda of the 101st Congress will be dictated by the need to put our nation's fiscal house in order by reducing the budget deficit.[2] Absent offsetting adjustments, increases in social security benefits will necessarily add to projected budget deficits and in slowing the growth of trust fund reserves, will delay the attainment of adequate contingency reserve levels. In recent reports we have recommended that no actions be taken that reduce the current accumulation of social security trust fund reserves, at least until such time as an adequate contingency reserve level is achieved.[3] Current projections show that such a level will be attained in the mid-1990s. Thus, regardless of

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[2] U.S.General Accounting Office, The Budget Deficit (GAO/OCG-89-1TR, Nov.1988)

[3] U.S.General Accounting Office, Health and Human Services Issues (GAO/OCG-89-10TR, Nov.1988)

the perceived merits of addressing the notch issue, doing so may not be a prudent course of action at this time, in light of the need to reduce deficits, meet other pressing national needs and maintain the social security system on a path toward financial health.

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

GAO

Replacement Rates for an Average Earner Retiring at Age 65, 1965–2010