Social Security: The Notch Issue

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Summary

Some Social Security beneficiaries who were born from 1917 to 1921—the so-called notch babies—believe they are not receiving fair Social Security benefits. (The Social Security Administration (SSA) and a 1994 commission on the notch issue define the notch period as 1917 to 1921, though some advocates define the period as 1917 to 1926.) The notch issue resulted from legislative changes to Social Security during the 1970s. The 1972 Amendments to the Social Security Act first established cost-of-living adjustments (COLAs) for Social Security. This change was intended to adjust benefits for inflation automatically, but an error caused benefits to rise substantially faster than inflation.

Congress corrected the error in the 1977 Amendments. However, benefits for those born from 1910 to 1916 were calculated using the flawed formula, giving them unintended windfall benefits. The notch babies, born from 1917 to 1921, became eligible for benefits during the period in which the corrected formula was phased in. For many who retired during in this phase-in period, however, the transition formula did not lessen the differential between their benefits and the windfall benefits received by people born in earlier cohorts. Some notch babies feel it is unfair that their benefits are lower than those received by the older individuals who received the windfall, and also that the transition formula did not do enough to make up the difference.

A number of legislative attempts have been made over the years to give notch babies additional benefits, but none have been successful. A congressionally mandated commission studied the issue and concluded in its 1994 report that "benefits paid to those in the 'Notch' years are equitable, and no remedial legislation is in order."

Any future change to the Social Security benefit formula has the potential to create a notch. This is an important consideration as lawmakers consider changes to ensure long-term system solvency.

Contents

Figures

Contacts

Origins of the Notch

The 1972 Amendments

Congress approved legislation in 1972 to adjust Social Security benefits for inflation automatically (P.L. 92-336). However, the formula for calculating the new cost-of-living adjustment (COLA) was flawed. Although intended to provide inflation adjustments only to people already receiving benefits, each increase for current beneficiaries also raised the initial benefits of future beneficiaries. The formula assumed that wages would continue to rise faster than prices, as they had in the past. However, the high inflation and unemployment in the 1970s resulted in higher-than-intended increases for beneficiaries affected by the new formula, and lower-than-expected revenues for Social Security.[1] If the erroneous formula had not been changed, future beneficiaries could have received initial benefits that exceeded their pre-retirement earnings—higher than Congress intended and higher than payroll taxes could finance.[2]

The 1977 Amendments

As part of the 1977 Amendments (P.L. 95-216), Congress corrected the error in the benefit formula in the 1972 Amendments by creating a new formula in which initial benefit levels are indexed to wages, then increased by inflation after the initial year. Without the 1977 Amendments, the system would have become insolvent within five years.[3] The correction to the benefit formula resulted in different treatment for all Social Security beneficiaries depending on year of birth, as described in the following section.[4]

Benefit Levels Before, During, and After the Notch

Beneficiaries Born from 1910 to 1916

The erroneous benefit formula created by the 1972 Amendments affected people who turned 62 in 1972 or later—that is, individuals born in 1910 and later. This is because the formula used to calculate Social Security retirement benefits is based on the year an individual reaches the earliest age of eligibility, which is age 62. When the error in the benefit formula was corrected in the 1977 Amendments, benefits for people who were already eligible for retirement benefits were left unchanged. As a result, beneficiaries born between 1910 and 1916—the seven years prior to the notch—were allowed to receive unintentional windfall benefits for the rest of their lives.

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[1] For example, annual inflation averaged over 7% during the 1972-1977 period, compared to less than 3% from 2002-2007. (U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index-All Urban Consumers (CPI-U) 1913 to present, at ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt.)

[2] *1977 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, May 10, 1977. (1977 *Trustees Report*.)

[3] 1977 *Trustees Report*.

[4] See also Social Security Administration, *The "Notch" Provision*, SSA Publication No. 05-10042, January 2004, at http://www.ssa.gov/pubs/10042.pdf.

Beneficiaries Born from 1917 to 1921

The 1977 Amendments corrected the error in the Social Security benefit formula, starting with individuals born in 1917. As a result, the benefits of people who were born during the notch years are lower than those of the beneficiaries who came just before them. To ease the transition to the new, corrected formula, Congress phased in the change for people born from 1917 through 1921—the notch babies.[5] For many who retired during in this phase-in period, however, the transition formula did not lessen the differential between their benefits and the windfall benefits received by people born in earlier cohorts.[6]

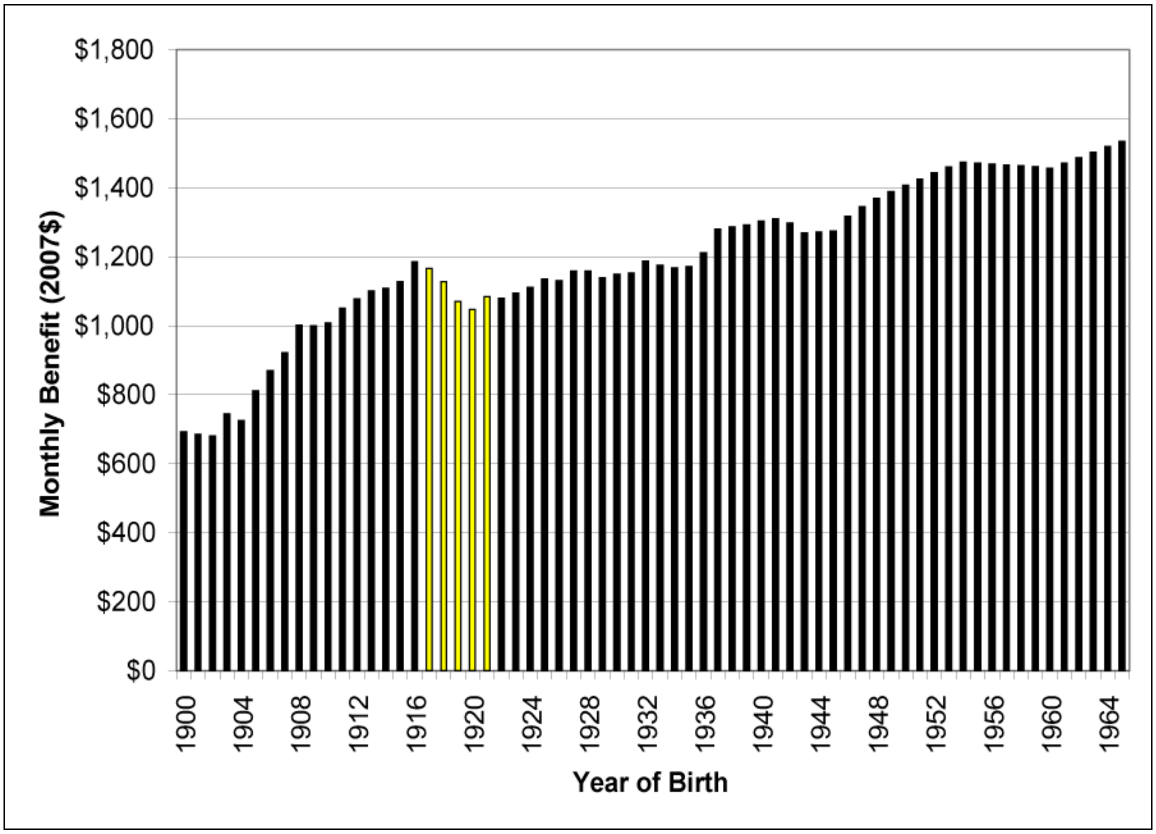
Figure 1 shows inflation-adjusted initial monthly benefit amounts for average wage earners born from 1900 to 1965. The notch babies' birth years are shown in yellow. The term "notch" originated from graphs such as this one, where the lines representing the benefit levels of notch babies dip below the lines representing the benefit levels of individuals born immediately before and soon after.

Many notch babies actually receive higher real benefits than people who were born after they were, all else equal. For example, people born in 1917 receive higher average monthly benefits than people born in 1922 (the first year the correct formula was fully phased in). As shown in **Figure 1**, an average wage earner born in 1917 would receive a monthly benefit of $1,166 (in 2007 dollars), while an average wage earner born in 1922 would receive a monthly benefit of $1,080.

[5] As of December 2009, roughly 1.8 million—about 6%—of Social Security retired worker beneficiaries were born from 1917 to 1921, and thus are considered notch babies. (SSA, *Annual Statistical Supplement, 2010*, Table 5.A1.1, at http://www.socialsecurity.gov/policy/docs/statcomps/supplement/2010/5a.html.)

[6] James W. Kelley and Joseph R. Humphreys, "Congressional Intent Concerning the Notch Issue," at http://www.ssa.gov/history/notchfile3.html.

Figure 1. Initial Benefit Amounts for Average Wage Earners Retiring at Age 65 in 2007 Dollars



Source: 2007 Social Security *Trustees Report*, Table VI.F10.

Note: The lines representing the notch period (1917-1921) are yellow. Average wage earners are assumed to have earnings equal to SSA's Average Wage Index (AWI) each year (about $40,000 in 2007).

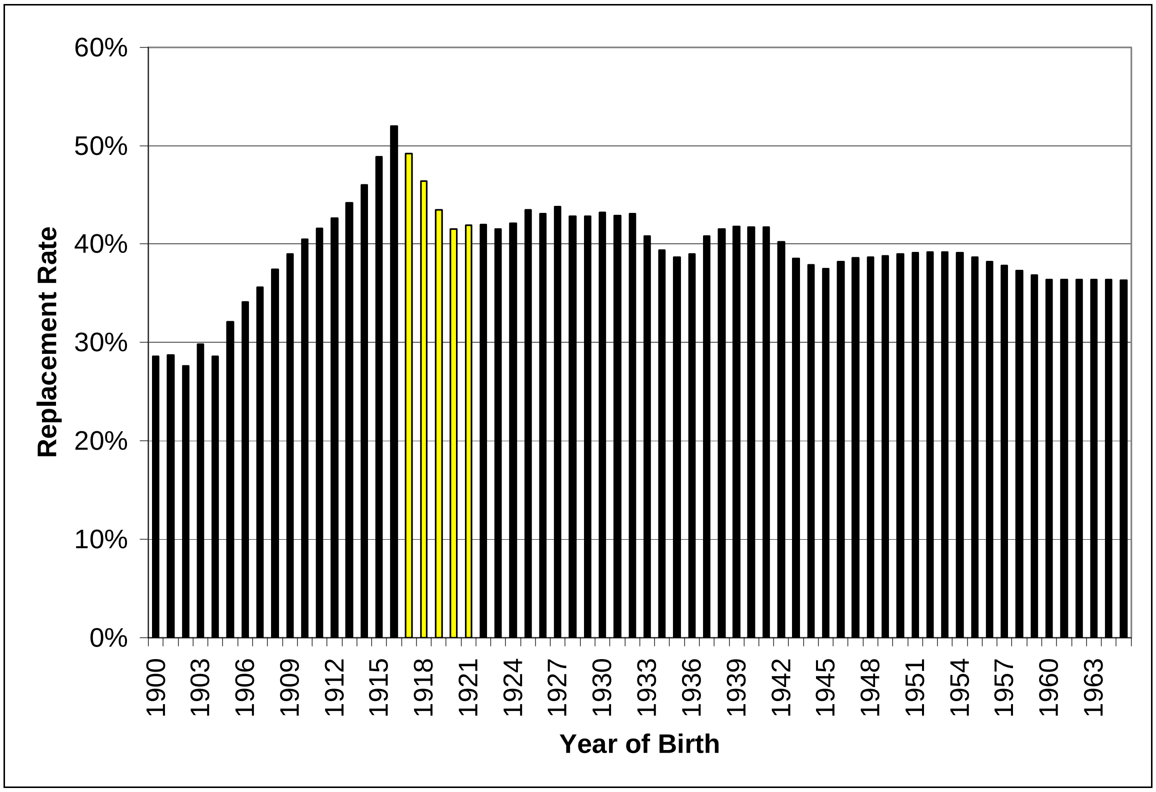
In addition, most notch babies have significantly higher replacement rates than people born after they were, all else equal. A *replacement rate* is one way of measuring the adequacy of a person's post-retirement income; it is a comparison between a person's income before and after retirement. This report calculates replacement rates in the same way as the Social Security Administration (SSA) actuaries, which is to show the proportion of beneficiaries' average indexed earnings replaced by their initial Social Security benefits. In 2007, the estimated replacement rate for an average wage earner retiring at age 65 was 40%.

In drafting the 1972 Amendments, Congress intended to maintain replacement rates at roughly 40%, but the double-indexing error caused replacement rates to rise above 50% before the error was fixed, as shown in **Figure 2** below. The notch babies' replacement rates are higher than most beneficiaries born after they were—particularly in comparison to current and future beneficiaries, whose replacement rates are declining as the full retirement age increases.

Beneficiaries Born after 1921

Benefits for people born in 1922 and later are calculated using the new, corrected formula established by the 1977 Amendments. This formula is currently being used to calculate the annual initial retirement benefit.

Figure 2. Replacement Rates for Average Wage Earners Retiring at Age 65



Source: 2007 Social Security *Trustees Report*, Table VI.F10.

Note: The lines representing the notch period (1917-1921) are yellow. Average wage earners are assumed to have earnings equal to SSA's Average Wage Index (AWI) each year (about $40,000 in 2007).

Commission on the Social Security Notch Issue

In 1992, Congress voted to establish a 12-member commission to study the notch issue. The Commission on the Social Security "Notch" Issue released its report on December 31, 1994.[7] Its principal conclusion was that the "benefits paid to those in the 'Notch' years are equitable, and no remedial legislation is in order."[8] Its report states that "the uneven treatment between those in the 'Notch' years and those just before them was magnified by the decision of Congress to fully grandfather" people born before 1917 under the old law. It further states that "in retrospect" Congress "probably should have" limited the benefits of those whose benefits were calculated using the erroneous formula in the 1972 Amendments, but that it was too late to do so given their advanced age.

[7] The Commission on the Social Security "Notch" Issue, *Final Report on the Social Security "Notch" Issue*, December 31, 1994, at http://www.ssa.gov/history/notchbase.html.

[8] GAO also found that "the facts suggest the notch group is treated fairly." See "Social Security: GAO's Analysis of the Notch Issue," at http://archive.gao.gov/t2pbat2/152530.pdf.

Advocacy Group Activity

Among advocacy groups, support for legislation to increase benefits for notch babies has been limited. The lead proponent of such legislation is the TREA Senior Citizens League (TSCL). Some Members have complained that TSCL has misled seniors about the issue in mailings that solicit money.[9] A few veterans' groups and grassroots notch groups also have supported notch legislation.

Most other organizations representing older Americans, led by AARP, have opposed notch legislation. The AFL-CIO, the National Association of Manufacturers, and the National Taxpayers Union also have come out in opposition, as did the Carter, Reagan, and George H. W. Bush Administrations. The Clinton Administration, the George W. Bush Administration, and, to date, the Obama Administration have taken no position.

Potential for Future Notches

One lesson from the experience of the notch babies is that almost any change to Social Security benefits can create a notch. Whenever benefits increase or decrease at some specific point along a continuum—most commonly a point defined by date of birth, income, or assets—a notch or "cliff" can result at the point on the continuum where the benefits rise or fall. For example, if benefits are increased for everyone born before (or after) a certain date, a downward notch in benefits will occur for beneficiaries whose date of birth is after (or before) that date.

Notches are quite common in means-tested programs, such as Supplemental Security Income (SSI), in which benefits are conditioned on having income or assets under a certain threshold. For example if an aged or disabled person who lives alone has no other income and has assets of less than $2,000, he or she is eligible for a federal SSI benefit of $674 per month in 2011. If he or she has assets of $2,001, then the individual is ineligible for benefits in that month.

An alternative to creating a "notch" or "cliff" in benefits would be to phase in the change in benefits over a range, whether it be a range of birth years, a range of income, or a range of assets. The disadvantages of phasing in changes in benefit levels over a range of birth years, income or assets, are that it can target the desired change less precisely and can sometimes raise the total cost of the program. Take, for example, a hypothetical proposal to reduce the deficit of the Social Security trust funds by reducing the benefits of all old-age beneficiaries born after 1969 by 10%. This would create a notch based on one's date of birth. Other things being equal, two retired workers with identical career average earnings who were born one day apart on December 31, 1969 and January 1, 1970, respectively, would have benefits that would differ by 10%.

Another alternative would be to phase in the change over a range of birth years. This would replace the notch with a slope. Depending on the specifics of the phase-in, the approach could result in total expenditures that are higher or lower. For example, if the reduction were phased in at the rate of one percentage point per year, beginning with a 1% reduction for those born after

[9] See transcript of hearing, "Misleading Mailings Targeted to Seniors" before the Subcommittee on Social Security of the Committee on Ways and Means, Serial 107-44, July 26, 2001, at http://waysandmeans.house.gov/legacy/socsec/107cong/7-26-01/107-44final.htm.

December 31, 1960, a 2% reduction for those born after December 31, 1961, etc., there would be no notch, and savings would be greater than under the original proposal. On the other hand, the reduction could be phased in at 1% per year beginning with those born after December 31, 1969. This, too, would eliminate the notch, but total savings would be less than under the original proposal.

In summary, a notch or cliff in benefits is a common consequence of conditioning the amount of benefits (or taxes) on an individual's location along a continuum based on date of birth, income, or assets. Notches can be eliminated by phasing in the change in benefits or taxes, but only at the cost of either targeting the change in benefits or taxes less precisely or spending more or less than would occur with a notch or cliff.

Legislative Activity

Over the years, many bills have been introduced in Congress to increase benefits for notch babies, but there has been little legislative action on them. In past Congresses, various attempts were made to gain support for discharge petitions to force the House Ways and Means Committee to report out a bill, but the sponsors were unable to get enough signatures. Notch legislation, however, did reach the Senate floor a number of times.

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