Social Security Administration
ISSUES AND ANSWERS

THE NOTCH

Background

The term "notch" is used to refer to the difference between benefit amounts payable to born after 1916 and those payable to workers with similar earnings histories born in 1916 earlier. The difference resulted from the 1977 amendments to the Social Security Act that the way Social Security benefits are computed.

Benefit Computation Changes

In 1975, automatic yearly cost-of-living adjustments to Social Security benefits were implemented. However, the method used to compute payment rates tended to overcompensate for inflation. Because of unusually high inflation in the 1970s, benefit rates for people initially affected by the new formula -- generally those born in 1910 and later -- increased dramatically. This indexation for inflation would have ultimately led to benefit payments higher than pre-retirement earnings for the average worker. Congress realized that something had to be done to stop benefit rates, restore more appropriate payment levels, and improve the financial condition of the program. This led to the computation changes in the 1977 amendments and the creation "notch."

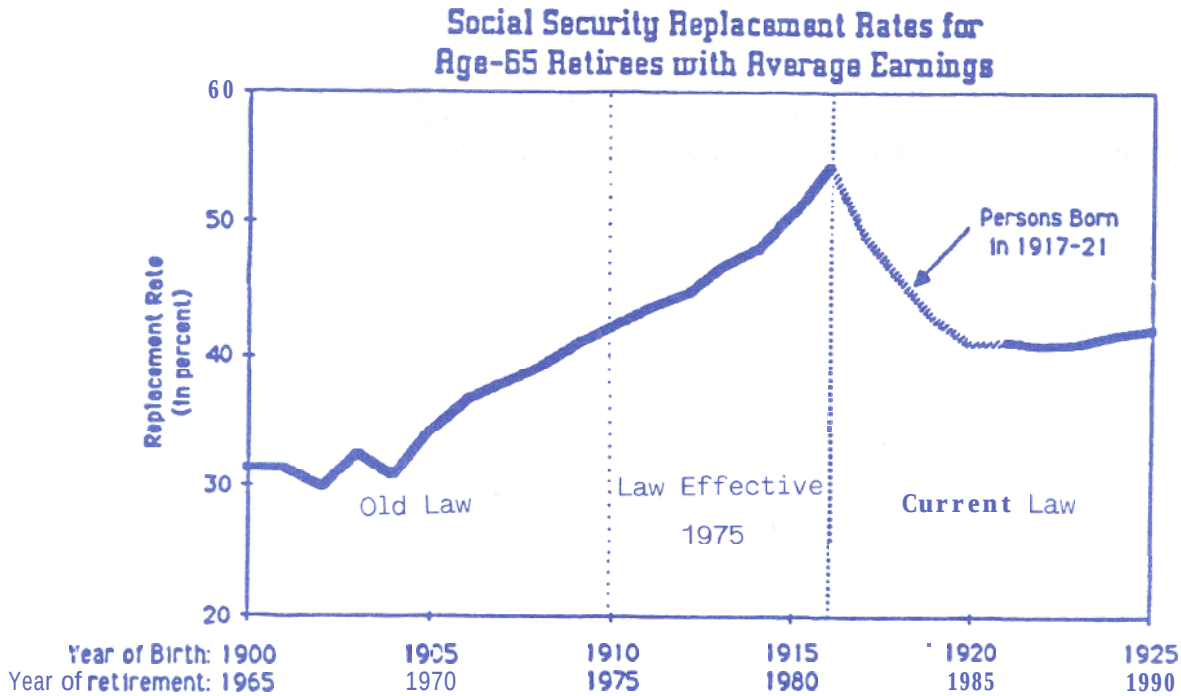
Replacement Rates

A Social Security benefit essentially represents a percentage of a person's average monthly working income based on a lifetime earnings history. The ratio of a worker's pre-retirement income replaced by Social Security is known as the "replacement rate."

Those rates vary because one of the precepts of Social Security provides for benefit computations to be structured so that low-income workers receive a greater replacement rate than do their higher-salaried counterparts. The rate for all workers is generally between 25% and 60%, but the replacement rate for a worker with average earnings is about 42%.

Because of the flaws in the computation method used beginning in 1975, replacement rates for people born after 19 10 began to climb to unprecedented and unintended levels, reaching 55% for workers with average earnings born in 1916. If left unchecked, the rates would have continued to climb to 100% and more.

As the graph on the back illustrates, the 1977 amendments reversed this trend and brought replacement rates down to their historical levels.



Transition Period ("Notch-Year Babies")

To ease the burden of the changeover for people approaching retirement age at the time the computation method was corrected, a five-year transition period was implemented. It called for special benefit computations that gradually lowered replacement rates for people born from 19 17 to 192 1. This is illustrated by the broken line in the graph.

In 1983, a popular newspaper advice columnist coined the phrase "notch-year babies," referring to people born in 19 17-21. The column incorrectly implied that these workers were singled out to receive benefits lower than those payable to people born either before 19 17 or after 1921 In reality, all workers born after 1916 have their benefits computed under the new method, resulting in generally lower (but more appropriate) payment levels. And in fact, because of the transition rules, many of the so-called "notch-year babies" receive slightly higher average replacement rates than do people born in 1922 and later.

A Notch or a Windfall?

As the graph clearly illustrates, a more appropriate way to view the notch is to consider that all people born during the years 19 10 through 1916 receive an unintended bonus in their monthly Social Security checks -- in effect, a windfall.

However, many people born after 1916 are resentful because they do not share in this good fortune. Public pressure on Congress is mounting to do something about this perceived injustice. Several proposals are under consideration that would reduce or eliminate the difference between benefits under the old and new computation methods. However, the costs of such proposals are very high, ranging from $24 billion to more than $375 billion through 1996.

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