New England Journal of Political Science

Volume 13
Number 1 *Volume XIII, Number 1*

Article 4

8-1-2023

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Recommended Citation
Eisner, Marc A. (2023) "Fiscal Crisis as Political Artifact: The Problem of Misplaced Trust," *New England Journal of Political Science*: Vol. 13: No. 1, Article 4.
Available at: https://digitalcommons.library.umaine.edu/nejps/vol13/iss1/4

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Fiscal Crisis as Political Artifact: The Problem of Misplaced Trust

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Abstract

This article examines how early decisions regarding the financial model supporting Social Security—a dedicated payroll tax and a fully-funded reserve account—shaped the understanding of revenue flows and, ultimately, the debt. Although the original model was discarded, the residual features of the model had unintended consequences. The segregation of payroll taxes from the general fund and the distinction between the debt held by the public and the intragovernmental debt accentuated concerns over an imminent fiscal crisis and created pressure for austerity in discretionary spending. The projections of trust fund insolvency, in turn, framed a larger narrative about the entitlement crisis. To what extent is the concern over crisis an artifact of a policy architecture that was abandoned long ago?

During the postwar period, the fiscal history of the United States has had three significant components. First, federal spending has become increasingly difficult to control. Programmatic mandatory spending—the programs that fall outside of the budgetary process—has claimed an ever-greater proportion of federal outlays. In the past half century, this category has doubled as a share of federal spending, from less than a third to two-thirds of outlays (Office of Management and Budget 2022, Table 8.3). The costs of the largest mandatory programs—Social Security, Medicare, and Medicaid—are driven by forces outside of the control of Congress (e.g., the aging of the population). The trajectory of growth cannot be altered without changes in the authorizing statutes, which could force members of Congress to incur significant political costs. Given the high levels of political polarization, the budgetary process has become a contentious, zero-sum game over discretionary spending, a shrinking share of federal outlays.

Second, there have been significant changes in the composition of revenues. During World War II, the individual income tax—which had previously fallen on a narrow stratum of the population—was converted into a mass tax with high marginal rates (Witte 1985, 110). During the 1980s, this tax regime was abandoned. As a product of the Economic Recovery Tax Act (1981) and the Tax Reform Act (1986), the top marginal tax rate was slashed from 70 to 28 percent. As the maintenance of low marginal rates became a core goal of the Republican Party, a return to the earlier tax regime proved impossible. In the wake of the 1980s tax cuts, the top rate moved within a range of 31 and 39.6 percent. At the same time, the corporate income tax declined markedly as a source of revenue and was eclipsed by the growth in social insurance taxes (e.g., the payroll tax)—the most regressive form of taxation.

Third, and reflective of the two trends noted above, the nation's fiscal position has deteriorated markedly. In the immediate wake of World War II, the debt held by the public was

106.1 percent of GDP, the highest in the nation's history.[1] The next several decades brought a significant reduction in the debt-GDP ratio—a product of the maintenance of steady revenues, relatively minor deficits, and fortuitous economic conditions. By 1974, the debt-to-GDP ratio was less than a quarter of what it had been in 1946. But the 1970s marked an inflection point, as stagflation forced a reconsideration of Keynesian demand management and the tax system created during the war. By the 1980s, the process of deleveraging came to an end and was replaced by the rapid growth of the debt (Office of Management and Budget 2022, Table 7.1). Four decades later, the debt-to-GDP ratio is at the highest level since World War II and the Congressional Budget Office projects that it will reach 185 percent of GDP by 2052. At that point, net interest on the debt will be the largest category of outlays (7.2 percent of GDP), surpassing Social Security (6.4 percent of GDP) or Medicare (5.9 percent of GDP).[2]

The deterioration of the nation's fiscal conditions has given rise to fears of an imminent fiscal crisis. Some analysts have focused on levels of indebtedness and the growing possibility that the market for US Treasuries may prove fragile as investors respond to a growing risk of default. Under these conditions, the federal government could be forced to embrace austerity policies to reduce the debt and/or pay higher risk premiums (Congressional Budget Office 2019, 13). Others have emphasized the role that public debt can play in crowding out private investment, thereby compromising future rates of economic growth, which could simultaneously increase the demand for government services and undermine revenues (Cottarelli 2017, 47-53; Reinhart and Rogoff 2010, 573-78; Checherita-Westphal and Rother 2012, 1392-1405; Égert 2015, 226-38). Finally, there are more specific concerns about the fiscal status of the largest mandatory programs (often framed as the "entitlement crisis"). Social Security Old Age, Survivors, and Disability Insurance and Medicare rely on revenues from the payroll tax, with

accumulated surpluses retained in trust funds. While these programs long appeared to be islands of stability in an otherwise chaotic fiscal sea, the trust funds face impending insolvency. Without statutory change, they will no longer be able to provide promised levels of support.

The larger story of the postwar period combines the unrelenting growth in programmatic mandatory spending and the constraints placed on revenues in a highly polarized political environment. As noted above, economic conditions of the late 1970s opened a window of opportunity to relitigate the policy mix that had prevailed in the wake of the New Deal. Opposition to the progressive mass-based income tax was a key element of this period, driven by supply-side arguments regarding the potential of deep tax cuts to spur economic growth and potentially raise additional revenues. The commitment to tax reduction and the maintenance of a low-tax regime became one of the central unifying elements in the conservative coalition. While there was a brief period of bipartisanship in the need for debt reduction during the 1990s, by the 2000s this consensus had deteriorated. The GOP was committed to using the budget reconciliation process to achieve deep cuts in marginal rates when in the majority (2001, 2003, 2017) and blocking tax increases when in the minority. Beset by high levels of polarization, the capacity of Congress to forge bipartisan support for fiscal constraint had diminished. Indeed, the basic steps required under the Congressional Budget Act of 1974 became elusive. Congress repeatedly failed to pass budget resolutions or appropriations bills prior to the beginning of the fiscal year, forcing government by continuing resolution. It relied on emergency supplemental appropriations to fund major commitments off-budget. While Congress passed the Budget Control Act of 2011 to reduce the deficit, it repeatedly lifted the spending caps and suspended the debt ceiling, deferring restraint to future generations of lawmakers. From 2001 to 2019, the

eve of the COVID-19 pandemic, the debt more than doubled, from 31.5 to 79.2 percent of GDP (Office of Management and Budget 2022, Table 7.1).

Although there have been robust debates on the political and programmatic origins of deficits and debt, this article takes a somewhat different approach, focusing on critical policy and institutional design decisions with respect to the financial structure of Social Security and, subsequently, Medicare. These decisions were shaped by the larger political goal of drawing a distinction between social "insurance" and "relief." The core argument is that the decision to fund Social Security (and subsequently Medicare) with payroll taxes and to credit surplus receipts to trust funds had several consequences. First, as the mix of federal revenues changed in the anti-tax environment of the 1980s to place a heavier reliance on earmarked payroll taxes, the proportion of revenues destined for the general fund declined. Because the general fund is the fiscal backbone of discretionary spending and appropriated entitlements like Medicaid, the flow of funds intensified the pressure for austerity. Second, the institutional design decisions when combined with demographic trends created concerns about trust fund insolvency that were unique to these programs. As the trust funds are depleted, redemptions must be financed through new taxes, a reduction of discretionary spending, or the issuance of public debt. Given the staunch opposition to tax increases within the Republican Party and the polarization-induced disorder in the congressional budget process, it is probable that intragovernmental debt will be converted into publicly held debt, further contributing to the growth of the debt-to-GDP ratio. In essence, the "entitlement crisis" was largely an artifact of original design decisions.

The Fiscal Path

Over the past few decades, there has been a renewed interest in the historical development of the American state and key public policies. The concept of path dependency has informed much of this research (Pierson 2004). The central features of path dependency are quite straightforward. Initially, policymakers may consider a range of options. But at critical junctures, even relatively minor decisions about the design of institutions or policies—particularly if they occur early in a longer sequence of decisions—can have a magnified effect, placing political development on a particular trajectory. Early decisions are most consequential if they are reinforced by positive feedback loops that buttress the trajectory of development, giving rise to an equilibrium that can prove resistant to change. Interest groups and political constituencies, for example, may consolidate around existing policies or a particular policy image, reinforcing the equilibrium (Baumgartner and Jones 2004; True, Jones and Baumgartner 2001). Other institutions may evolve in tandem. Political and institutional actors may have a powerful stake in defending the status quo, thereby raising the costs of departing from the existing path. New policies, when introduced in this context, may be layered upon the old, once again reinforcing early decisions. Even if early decisions appear, in retrospect, to be suboptimal, the difficulties of changing paths may prove too great to be negotiated, short of some major punctuation.

The power of path dependency is clearly exhibited in the history of the US social welfare state. Key decisions that were made by Congress and the Roosevelt administration at the time of the passage of the Social Security Act of 1935 would have long-term consequences for the development of the welfare state. The decision to draw a clear distinction between “social insurance” and “categorical relief,” for example, placed the two parts of the US welfare state on different trajectories of development. Social insurance programs (e.g., old age pensions) would

be funded through social insurance taxes or "contributions," and would be insulated from the kinds of political challenges that would plague relief programs (e.g., Aid to Dependent Children) that drew on the general fund of the Treasury. Old age pensions would be supplemented by employment-based pensions that were heavily subsidized through tax expenditures. The decision to omit health insurance from the Social Security Act of 1935 would create space for the rapid development of a private health insurance industry that would, once again, be heavily subsidized through the Internal Revenue Code. Three decades later, Congress passed the Social Security Act Amendments of 1965, creating Medicare, the healthcare entitlement for the elderly. Medicare was layered on top of the system of Social Security old age pensions, another social insurance program funded through the payroll tax. Private sector insurance policies, supported by tax expenditures, and the reliance on third-party providers (e.g., health plans), would both limit the magnitude of reform and insulate the policies for the elderly. Medicaid, a means-tested healthcare entitlement, would rely, once again, on general revenues and would be drawn into the ongoing contestation over the legitimacy of social welfare provision. Policies born in the same political moment were placed on very different paths.

While the decisions made in 1935 would carry significant ramifications for the development of the US welfare state more generally, they would also have profound and unintended consequences for fiscal policy. Early decisions about the funding mechanisms for Social Security (and later for Medicare) would have important implications for the classification of government revenues, the restrictions on the use of funds, and the understanding of the composition of the national debt. As the payroll tax grew in importance as a share of revenues, the general fund would be placed under increasing pressure. This would create pressures for austerity in discretionary spending while raising concerns about government financing more

generally. It is the core argument of this article that concerns over the looming fiscal crisis in the US have been, in part, an artifact of formative decisions regarding the organization of the welfare state. This is not to say that the persistent and growing fiscal gap and the rapid growth of the federal debt are insignificant problems. But debates over the larger budgetary challenges faced by the US would be clarified by understanding the extent to which early decisions about the welfare state shaped the larger fiscal dynamic.

Institutional Design Decisions

One of the most important legacies of the New Deal was the passage of the Social Security Act of 1935. Social Security old-age insurance is not markedly different from other redistributive programs that impose a broad-based tax to provide benefits to a particular group of recipients. And yet, original design decisions—largely made to provide an ideological framing that could differentiate old-age "insurance" from categorical "relief"—carried significant consequences. On the one hand, the decisions shaped expectations regarding the connection between "contributions" and the provision of benefits that insulated the program politically. On the other, it raised some novel issues for government finance.

New Dealers who framed the debates surrounding old-age insurance drew a clear distinction between relief and insurance. As the Committee on Economic Security noted in its 1935 report, most of the "dependent aged are now on relief lists and derive their support principally from the Federal Government" and the states which had laws providing for means-tested public assistance. For this population, the federal government should continue to provide one-half the cost of relief via Old-Age Assistance (limited to $15 per month). In contrast, the Committee recommended what would become Social Security Old-Age Insurance for younger workers, a form of forced savings, or a "contributory system of old-age annuities" that would

"enable younger workers, with matching contributions from their employers, to build up a more adequate old age protection than it is possible to achieve with noncontributory pensions based upon a means test" (Committee on Economic Security 1935, 308-9). As Theda Skocpol and G. John Ikenberry note, Social Security was framed "as a huge set of public piggy banks into which individual prospective 'beneficiaries' put away 'contributions' for their own eventual retirements." The political benefits of this framing and the provision of "accounts" with individual Social Security numbers were clear. The portrayal of Social Security as forced savings "supposedly established a kind of contractual bond or promise to repay with interest between the government and each individual contributor, thereby giving each person a sacred right eventually to collect the benefits he or she had earned" (1995, 182).

Old-Age Insurance, Carl Shoup argued, was different than other categories of government transfers that "seem[ed] to represent special benefits to certain groups within the community." Its financing was grounded in the "individual-sacrifice principle" insofar as it imposed "a sacrifice on the persons who are to receive the benefits and does not impose a sacrifice on the others in the community" (1939, 165). Once again, attention turned to the ideological framing of old-age pensions. As Shoup explained: "By receiving something to which he feels he has a legal and moral right, something that he has himself worked for and saved for, and by receiving it without having to prove a certain level of poverty, the beneficiary is thought to avoid a disintegration of morale that would accompany free pensions or benefits coupled with the means test" (1939, 173). Franklin D. Roosevelt clearly understood the political utility of the contributory payroll tax. As he reportedly explained: "We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions … With those taxes in there, no damn politician can ever scrap my social security program. Those taxes

aren't a matter of economics, they're straight politics" (DeWitt 2005). In the end, the Social Security Act created two separate tracks with different financial mechanisms. The public assistance track (Aid to Dependent Children, Old-Age Assistance, various forms of categorical assistance) would rely on general revenues, whereas the social insurance track (Old-Age Insurance and Unemployment Compensation) would rely on earmarked funds or "contributions" (Zelizer 2012, 154).

The Roosevelt administration could have opted some other policy architecture rather than social insurance. For example, it could have created a national system of income support for the elderly and the unemployed financed through general revenues. But as Paul Douglas noted in 1936, such a system would "arouse the opposition of the states-rights sentiments." Southern Democrats would prove skeptical of any program that would interfere with local race relations. Moreover, it would be prohibitively expensive and "would necessarily involve the universal application of a means test with all of the attendant humiliations involved." In time, it was anticipated that old-age insurance would expand and greatly reduce the need for categorical relief for the needy elderly. Insurance would displace welfare for the elderly (Douglas 1936, 2, 5-6).

A Fully Funded Old-Age Reserve Account

Under the Social Security Act, the Bureau of Internal Revenue would begin collecting payroll taxes in 1937—a 2 percent payroll tax split between employee and employer, increasing in intervals of 3 years until reaching a maximum of 6 percent in 1949. Payments were not scheduled to begin until 1942. In the early years, the number of "contributors" to the system would exceed the number of beneficiaries. But within thirty years, it was projected that a payroll tax sufficient to cover the outflow of funds would be prohibitively high, potentially creating

pressures to draw on the general fund of the Treasury. During the congressional debates that resulted in the passage of the Social Security Act, the Roosevelt administration rejected permanent federal expenditures for old-age pensions, insisting that the system should be self-supporting. Thus, the Social Security Act (Section 201) created an "Old-Age Reserve Account" in the Treasury. To avoid potential legal challenges, the receipts from the new payroll tax were not deposited directly into the Reserve Account. Rather, the Social Security Act authorized a budget appropriation to the Account and required that the funds be invested in Treasury issues, including special issue government bonds, subject to the requirement that they earn a yield of at least 3 percent (Garbade 2012, 255). The arrangement reduced the amount of marketable debt that the Treasury would have to issue to finance deficits. Rather than paying interest to private bondholders, the federal government could make these payments to the reserve fund (Linton 1939, 184-89). Reserve Account holdings, in short, would be used "to distribute a given burden fairly and wisely between the taxpayers of different periods of time" (Wilcox 1937, 454). Compound interest on the surpluses accumulated early in the life of the program, it was anticipated, would allow for the provision of benefits for future generations without significant increases in the payroll tax.

The existence of a large Reserve Account raised some obvious concerns for critics. Some of these were economic. For Keynesians, there were fears that the Account would decrease total purchasing power, aggravating cyclical recessions. But most of the problems were political. There was the possibility of congressional misuse. As large reserve funds accumulated, it might stimulate interest group pressures to spend reserves for projects unconnected with the goals of the Social Security Act (as Paul Douglas noted, the reserves could "furnish a temptation" for Congress to spend on "grandiose but economically unproductive public works and thus leave the

country saddled with a large interest burden" [1936, 8]). E.B. Schwulst, who recognized this problem, questioned whether at some future time "the government may be led, in the investment of the reserve funds, into destructive competition with private enterprise." More immediately, he feared that beneficiaries would see the accumulation of assets and "may very well cry loudly for increases in the payments to themselves," and Congress would respond by accelerating and increasing benefits (Schwulst 1937, 168).

The latter concern raised by Schwulst was prescient. With the Social Security Act Amendments of 1939, Congress accelerated the provision of benefits (they would commence in 1940 rather than 1942), made the formula for the determination of benefits more generous, expanded the coverage of Social Security to dependents and survivors, and suspended scheduled increases in the payroll tax. It also converted the Old Age Reserve Fund into the Federal Old-Age and Survivors Insurance Trust Fund to be overseen by a Board of Trustees composed of the Secretary of the Treasury, the Secretary of Labor, and the Chairman of the Social Security Board. In *Helvering v. Davis* (1937), the Supreme Court decided that Social Security was a constitutionally permissible exercise of congressional authority to spend money in aid of the general welfare, and thus did not run afoul of the 10th Amendment (*Helvering* v. *Davis* 1937). In response, the 1939 Amendments abandoned the circuitous funding mechanism introduced in 1935 and mandated that the receipts from the payroll tax be appropriated to the new trust fund.

Reflecting uncertainty about how the changes in the program would impact on actuarial balances, the Revenue Act of 1943 included the Murray-Vandenberg amendment authorizing the use of general revenues if the payroll tax proved insufficient to meet the growth in benefits. Now that Social Security had become a pay-as-you-go system, members of Congress were reluctant to support increases in the payroll tax unless needed to meet the immediate needs of providing

benefits. Between 1942 and 1947, scheduled increases in the payroll tax were suspended on seven occasions (Breslauer and Morton 2021, 7-11). As Julian E. Zelizer notes: “Together, the Vandenberg-Murray amendment and the tax freeze had thus jeopardized one of the main distinctions of social insurance. Congress had not only eliminated the accumulation of reserve but also had authorized the use of general revenue to pay for insurance benefits.” Absent the original commitment to the creation of a fully funded reserve and with the door open to a future reliance on the general fund, the reliance on the payroll tax was largely of symbolic importance. It distinguished social insurance from public assistance (Zelizer 2021, 7-11).

The Social Security Act Amendments of 1950 eliminated the Vandenberg-Murray amendment, foreclosing the option of general revenue funding. The extended freeze on tax rates was eliminated: Congress approved scheduled rate increases and raised the wage base to help finance the pay-as-you-go system. At the same time, it raised benefits by 77 percent—the first increase in benefits legislated since the passage of the original statute—and extended coverage to some 10 million workers (most importantly, regularly employed farm and domestic workers who had been excluded in 1935). With the Social Security Act Amendments of 1956, a new Disability Insurance program was created, providing cash benefits to workers aged 50-64 (Breslauer and Morton 2021, 14). Over the course of the next quarter century, Congress raised benefits significantly, passing increases in 1952 (12.5 percent), 1954 (13 percent), 1959 (7 percent), 1965 (7 percent), 1968 (13 percent), 1970 (15 percent), 1971 (10 percent), 1972 (20 percent), and 1974 (11 percent). Thereafter, under the provisions of the Social Security Act Amendments of 1972, annual cost-of-living increases would be awarded based on the CPI-W (Social Security Administration. n.d.). While the trust fund continued to serve a purpose, the full reserve would never come to fruition.

The Model Extended

Three decades after the passage of the Social Security Act, Congress passed the landmark Social Security Act Amendments of 1965, partially filling the most significant gap in the original statute. Under Title XVIII, Congress created Medicare, a new healthcare entitlement for the elderly. Under Title XIX, it created Medicaid, a parallel means-tested entitlement for low-income Americans (Mayes 2004, 45-60). Echoing the earlier debates in Social Security, the two new healthcare policies would have different financial mechanisms. Medicare Part A, Hospital Insurance, would be funded through a new payroll tax that would be channeled to the Medicare Hospital Insurance trust fund. As in 1935, it would be framed as social insurance—an extension of the "contractual bond" initiated under Social Security. In the words of Lawrence D. Brown and Michael S. Sparer, "Social insurance funding conferred legitimacy. Medicare was a social contract between the state and contributing citizens, who later reaped what they had sowed, not a handout" (Brown and Sparer 2005, 3:78). Medicaid, in sharp contrast, would be financed through general revenues and framed as a form of social welfare. Like the relief components of the original Social Security Act, it would provide states with a great deal of latitude in implementation, a factor that was necessary to secure southern support in Congress (Boychuk 2008, 59-79).

The distinction drawn in the 1935 debates would be far less applicable with the new healthcare programs for two reasons. First, Medicare had voluntary components, including Part B (outpatient services) and later, Part D (prescription drugs, added in 2003), both of which would be funded through a combination of premiums and general revenues. Second, the distinction between social insurance and means-tested welfare would be less meaningful as the membrane between Medicare and Medicaid became increasingly porous. A significant and growing

proportion of the elderly would be "dual eligible," relying on some combination of Medicare and Medicaid. Some Medicaid recipients would become eligible for Medicare as a product of age; some Medicare recipients would become eligible for Medicaid as the costs of extended care depleted their retirement savings.

The Composition of Revenue and The Pressure for Austerity

The postwar period brought important changes in the composition of federal revenues, as shown in Figure 1. There was relative stability in the percentage of revenues generated from the individual income tax, despite deep reductions in progressivity following the Economic Recovery Tax Act (1981) and the Tax Reform Act (1986). The most significant changes came in the share of revenues generated by the corporate income tax and the social insurance taxes. In 1946, corporate income tax constituted 30.2 percent of revenues (5.2 percent of GDP). But by 1983, the share of revenue had fallen to 6.2 percent (1 percent of GDP), increasing to 14.7 percent (2.6 percent GDP in 2006) before entering a new period of decline (6.2 percent of revenues, 1.1 percent of GDP in 2019). The changes stemmed from reductions in the top corporate rate and changes in the individual income tax, which created incentives for firms to reorganize as pass through entities (e.g., sole proprietorships, partnerships, limited liability companies and S-corporations). Social insurance taxes, in sharp contrast, provided 7.9 percent of revenues in 1946 (1.4 percent of GDP) and increased steadily thereafter, reaching a peak of 42.3 percent of revenues (6.3 percent of GDP) by 2003 (Office of Management and Budget 2022, Tables 2.2, 2.3). The growth in the social insurance tax stemmed from increases in the payroll tax and the decision to eliminate the earnings cap for the Medicare portion of the payroll tax.

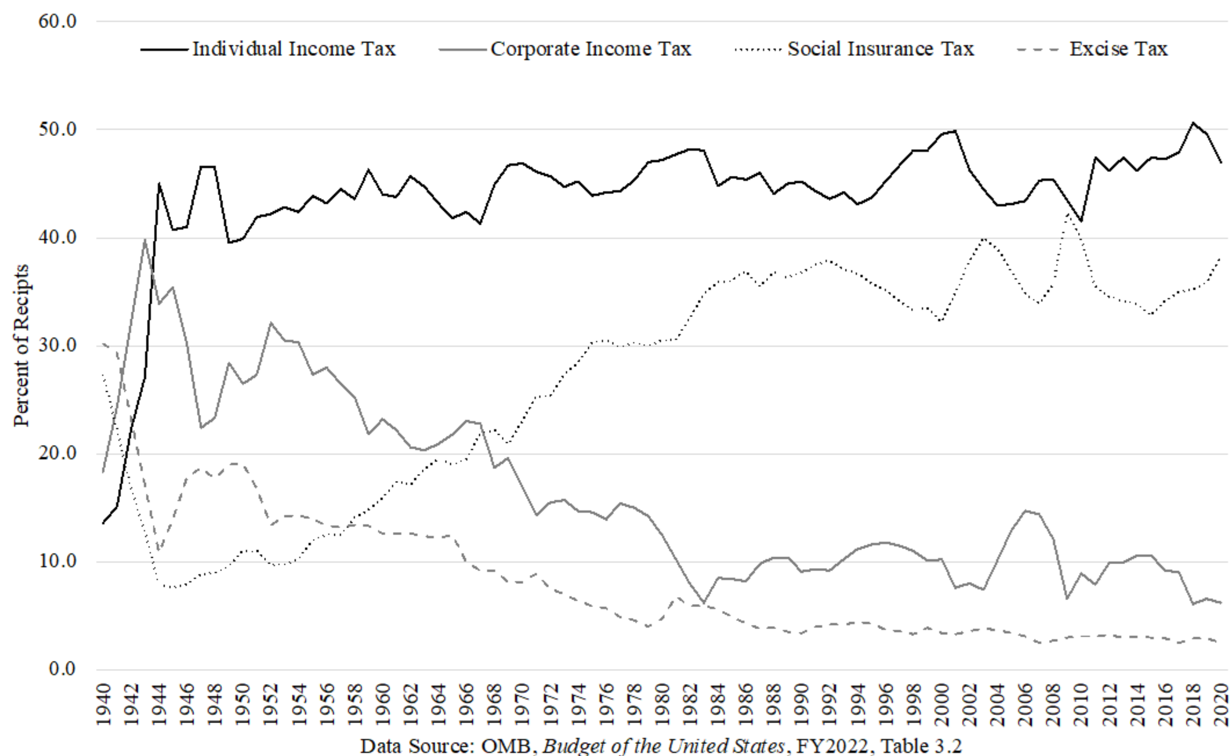

Figure 1. Composition of Federal Receipts, 1940-2020

Historically, the reliance on the individual and corporate income tax in the US reflected the Progressives' belief in the importance of taxation as an instrument of income redistribution, an emphasis that extended for several decades (Mehrotra 2013; Prasad 2012, 125-29). While the redistribution of income via the tax system made implicit sense, high marginal rates rendered the revenue system highly vulnerable to political challenges. Since the 1980s, the contemporary story of taxation is one of rate reductions (largely maintained in the post-1980s decades) which stripped the income tax of much of its progressivity. There is much to suggest that a reduced reliance on progressive income taxes relative to less visible taxes (e.g., consumption taxes) might have produced a different political dynamic. As Harold L. Wilensky noted: "Among the myths embraced by the American left, the most misleading is that the road to equality runs through progressive income taxes and taxes on business and property." Nations that have embraced less

visible and universally applied tax instruments (e.g., the value-added tax), have enjoyed a far more stable source of revenues. The revenues, in turn, have allowed for a higher level of redistribution via social programs. In the words of Wilensky, "the main mistake is to believe that by riveting one's attention on the tax side of the taxing/spending equation, one can achieve much of anything on the center-left agenda" (Wilensky 2002, 715; Prasad and Deng 201, 431-57). Perhaps the movement toward more regressive payroll taxes could have an impact comparable to the European reliance on consumption taxes?

The deep cuts in marginal tax rates and an increase in the role of social insurance taxes reflected the anti-tax sentiments of the post-1970s period. The payroll tax was far less visible than income taxes. At the same time, it was linked to specific programs and to the future provision of benefits (the connection that Roosevelt and Congress had banked on to negotiate the ideological contours of the 1930s in designing the Social Security system). Indeed, while Reagan was staunchly opposed to any efforts to reverse the tax cuts passed in 1981, he could accept increases in the payroll tax because they were already scheduled and could be framed as a reduction in benefits. Nonetheless, the larger fiscal implications were clear. By earmarking a growing share of revenues for the related trust funds and legally segregating them from the general fund of the Treasury, the role of the payroll tax in stabilizing the revenues of the federal government was vitiated. Absent an increase in overall revenues, the growth of the payroll tax imposed a constraint on the funds available for discretionary spending (Patashnik 2000, 40-62).

To understand why the greater reliance on payroll taxes fails to have this effect, a brief foray into federal finances in in order. Federal spending, when taken as a whole, draws on two groups of funds: federal funds and trust funds. The federal funds group is dominated by the general fund, which is used to finance the daily and long-term operations of the federal

government (it also includes several special and revolving funds that are not directly relevant to the current discussion) (Office of Management and Budget 2020, 287-93). The general fund is financed largely by the individual and corporate income tax. When these revenues are insufficient to cover the expenditures, the resulting deficit is met through borrowing. In contrast, the trust funds are financed through taxes that are legally dedicated to a specific purpose (e.g., the payroll tax is dedicated to the Old-Age Survivors and Disability Insurance or OASDI and Medicare trust funds). By law, the revenues that are assigned to trust funds cannot be comingled with the general fund. Unlike the federal funds, trust funds can become depleted and ultimately insolvent, but they cannot incur deficits.

The special treatment of mandatory spending programs supported by the payroll tax and trust funds magnified the concerns over the growth of the deficit and debt. The federal government draws a distinction between the on-budget deficit/surplus, and the off-budget deficit/surplus. By statute, the Social Security Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds are presented separately as off-budget (Levit 2014; Huston and Heniff 2020). Largely as a result of the Social Security Act Amendments of 1983 (see below), payroll receipts exceeded expenditures in every year from 1985-2020, generating large surpluses in the trust funds. At the same time, the deep tax cuts of the 1980s when combined with a failure to achieve commensurate reductions in spending, generated large and persistent on-budget deficits and a growing national debt. To place things in context, in 1990, on-budget revenues were 12.7 percent of GDP and on-budget outlays were 17.4 percent of GDP, generating a deficit of 4.7 percent of GDP. In that same year, off-budget revenues were 4.8 percent of GDP and off-budget outlays were 3.8 percent of GDP, generating a surplus of 1 percent of GDP. In

essence, 21.3 percent of the on-budget deficit was an artifact of the accounting treatment of the trust funds (Office of Management and Budget 2022, Table 1.2).

Between 1990 and 2001, Congress and presidents George H.W. Bush and Bill Clinton imposed new budgetary controls designed to eliminate the deficit and reduce the debt—a task that may have appeared less urgent if the growing off-budget surpluses had been combined with the on-budget deficits. Under the Omnibus Budget Reconciliation Acts (OBRA) of 1990 and 1993, individual tax rates were increased, generating the largest flow of revenues relative to GDP in the postwar period. The Budget Enforcement Act, Title XIII of OBRA 1990, as extended by OBRA 1993 and the Balanced Budget Act of 1997, imposed discretionary spending caps and pay-as-you-go rules that required that new mandatory spending and tax cuts be deficit neutral. The net effect was to reduce domestic discretionary spending from 3.4 to 3.2 percent of GDP—a level of spending lower than existed during any year of the Reagan presidency—and to generate budget surpluses by the end of the decade (Office of Management and Budget 2022, Table 8.4). When taken together, the imposition of higher social insurance taxes, relative austerity in non-defense discretionary spending, and larger programmatic changes (e.g., the 1996 elimination of AFDC) had a cumulative effect on lower-income households. Much of this would have been difficult to justify if not for the heightened salience of the deficit and debt in the 1980s and 1990s.

Of course, the achievement of surpluses in the late-1990s would prove ephemeral. In the 2000s, Congress jettisoned the budgeting rules enacted in the 1990s. The new Bush administration used the projected future surpluses to justify the deepest tax cuts since the Reagan era, secured and extended by Republican majorities through the budget reconciliation process as a means of avoiding the threat or reality of a Senate filibuster. When combined with two wars—

largely funded off-budget through emergency supplemental appropriations—and the creation of Medicare Part D, the largest increase in entitlement spending since the passage of Social Security Act Amendments of 1965, surpluses turned to persistent deficits. Beset by political polarization and razor-thin majorities, Congress would prove incapable of executing even the most basic obligations under the Congressional Budget Act (e.g., the passage of budget resolutions and annual appropriations bills). The financial crisis and the Great Recession would add significantly to the debt. And a new round of tax cuts in 2017 followed by the COVID-19 pandemic would push the debt to levels not experienced since the immediate aftermath of World War II.

The "Entitlement Crisis" And the Problem of Insolvency

When Congress decided in 1939 to commence Social Security payments early, expand the universe of beneficiaries, and delay scheduled payroll tax increases, it departed from the original institutional design decision to build a fully funded Old-Age Reserve Account. The goal of creating an account that could fund future beneficiaries by supplementing the payroll tax with compound interest from government bonds was abandoned. Soon thereafter, the option of relying on the general fund of the Treasury to supplement the payroll tax was foreclosed. Social Security would operate largely on a pay-as-you-go basis. Subsequent increases in the wage base and the payroll tax rate would be tethered to the costs of benefits and attention would turn, repeatedly, to the adequacy of the OASDI trust fund, even though it no longer served its original purpose.

Concerns over the trust fund insolvency grew in the latter half of the 1970s, as annual program deficits had become a common occurrence. Congress responded with piecemeal measures that allowed for the reallocation of payroll tax revenues between trust funds and authorized temporary inter-fund borrowing. After some highly politicized missteps, President Reagan issued Executive Order 12335 (1981) to establish the National Commission on Social

Security Reform, which he placed under the chairmanship of Alan Greenspan. As the Commission's work commenced, the 1982 report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds informed Congress that insolvency was imminent, noting: "Without corrective legislation in the very near future" the OASI trust fund "will be unable to make benefit payments on time beginning no later than July 1983." Assets had been so depleted that it "will not be able to continue making up the difference between outgo and income much longer. If assets are allowed to decline to the point where their amount at the end of a particular month is less than the benefit payments falling due on the third of the following month, inability to pay some benefit on time for that month would result" (Board of Trustees 1982, 2).

Under these conditions, the Greenspan Commission completed its report on January 1983 and recommended measures to increase revenues and reduce benefits. It recommended broadening the coverage of Social Security to include federal civilian employees and non-profit organizations, accelerating scheduled increases in the payroll tax rate, delaying the cost-of-living adjustment, and subjecting up to 50 percent of the benefits of high-income households to income taxation. In the end, Congress accepted the recommendations of the Commission and included a phased increase in the age of eligibility for full benefits from 65 to 67 by 2027. Given the warning issued by the Trustees Report, Congress moved with incredible rapidity in considering the reform proposals and by April 20, the Social Security Amendments of 1983 had been signed into law.

During the deliberations of the Greenspan Commission, members recognized the need for a "fail-safe" mechanism other than inter-fund borrowing that could be used to manage future crisis situations. It considered a range of possibilities, including borrowing from the general

fund, permitting the OASDI trust fund to issue its own bonds for sale to the public, and automatic increases in revenues or reductions in benefits. But strong disagreements within the Commission prevented it from recommending any fail-safe mechanism to Congress. Congress rejected any proposal that the trust funds be allowed to borrow from the general fund. At the same time, it reinstated authorization for interfund borrowing, but set restrictions on transfers between the OASDI and Medicare's Hospital Insurance trust funds. Congress also strengthened reporting requirements for the Board of Trustees should trust fund ratios be projected to reach 20 percent of benefits (Svahn and Ross 1983, 28-29).

The Social Security Act Amendments of 1983 were successful in avoiding insolvency. Prior to the passage of the Amendments, the OASDI trust fund had been hemorrhaging funds, falling from a high of $44.9 billion in 1974 to $24.9 billion in 1983. Thereafter, the OASDI trust fund grew rapidly, reaching $225.3 billion by 1990, surpassing $1 trillion by 2000, $2.61 trillion in 2010, and $2.9 trillion by 2020 (SSA "Old Age" n.d.). The trust fund was in a position few could have predicted in 1983. While there is much to celebrate, the aging of the population will quickly devour these reserves. According to the Social Security Trustee report, costs surpassed revenues in 2021 and the combined OASDI trust fund is projected to be insolvent by 2034, at which time revenues (payroll tax, taxation of benefit for higher income earners) would be sufficient to cover 77 percent of scheduled benefits. There are no provisions in the Social Security Act to make up the benefit reductions via infusions from the general fund (Board of Trustees 2021, 4-6).

Medicare's trust fund structure is more complicated than that of Social Security. The Hospital Insurance (HI) trust fund, which covers the mandatory component of Medicare (Part A), is funded by a combination of payroll taxes and some of the revenues generated by the taxation

of Social Security benefits of high-income recipients. The Supplementary Medical Insurance (SMI) trust fund, which covers the voluntary components of Medicare (Parts B and D), is funded by a combination of premiums and general revenues, both of which are adjusted annually. Given the financial model, the SMI trust fund cannot go insolvent. But the HI trust fund is more fragile than the Social Security trust funds. When Medicare commenced operation on July 1, 1966, some 19 million individuals automatically became beneficiaries; unlike Social Security, they did not prefund any of their future healthcare costs. “Medicare’s structure precluded it from experiencing a ‘grace period’ in which its trust funds could build up some measure of reserves from previous surpluses,” Rick Mayes notes. As a result, it “began operation as a genuine ‘pay as you go’ system” (Mays 2007, 25-26). This, combined with a rapidly growing number of beneficiaries, the medical inflation rate, and ongoing problems of cost controls, took their toll. The Medicare Trustees project annual deficits until the HI trust fund is depleted in 2028. As with Social Security, there is no statutory authority to draw on the general fund. Absent legislative action, revenues would cover 90 percent of expenditures, a figure which would fall to 78 percent by 2044 (Board of Trustees 2020, 60).

The growing costs of programmatic mandatory spending and the issue of trust fund insolvency have been central to the discourse surrounding the “entitlement crisis.” The growth in costs, it is argued, are unsustainable given the fragility of the underlying trust funds. As they are exhausted, the federal government will no longer be able to meet its obligations to recipients. Commentators on the right have periodically invoked the crisis narrative as a way of framing various entitlement reforms, including the full or partial privatization of Social Security and cost containment in Medicare through vouchers or, at the extreme, the movement to a fully privatized system supported by private health savings incentivized through the tax code. On the left, the

crisis narrative has gained fewer adherents. A combination of incremental reforms could extend the life of the OASDI trust fund, deferring more substantial changes for another day. Medicare, in contrast, is more complex, given the medical inflation rate and the long and checkered history of reforms that sought—with mixed success—to limit costs without compromising the quality or supply of healthcare. Given the seemingly uncontrollable growth of public health care costs, perhaps the only solution is more comprehensive healthcare reform?

To what extent should trust fund insolvency—or the "entitlement crisis," as some describe it—be a concern? There are two responses. First, the institutional design—an earmarked payroll tax and trust fund structure—has generated questions that are unique to Social Security (and to a lesser extent, Medicare, given its reliance on premiums and general revenues under Parts B and D). Discussions regarding the annual expenditures for other significant federal commitments are not tethered to questions of trust fund solvency. The annual spending for the Department of Defense (the largest of discretionary outlays) or appropriated entitlements like Medicaid are not framed by projections of the 75-year actuarial balances in the related trust funds because such trust funds do not exist. Financed by the general fund of the Treasury, a question regarding their "solvency" would be a category error. Ideally, levels of spending on these and other programs would reflect political deliberation regarding the relative importance of the underlying policy commitments and their implications for tax policy (Buchanan 2017).

One might argue, furthermore, that the depletion of Social Security trust fund surpluses should not as great a concern for a second reason: their depletion was fully anticipated. The Social Security Act Amendments of 1983, passed in clear recognition of the fiscal consequences of demographic trends, reflected a prudent decision to generate surpluses to pre-fund the retirement of the baby boom generation. Although private savings provide an imperfect analogy,

households save in anticipation of the costs that will be incurred later in life. The dissaving at the time of retirement is not considered an indicator of crisis. Indeed, it is precisely the point. The question of whether subsequent generations will prefund their own retirements collectively via statutory change is a political one (Buchanan 2017). Given the projections of trust fund insolvency, Congress could elect to amend the Social Security Act to once again raise the payroll tax or eliminate the earnings cap, subject a greater share of benefits of higher income households to income taxation, or change the calculation of benefits (e.g., through changes in the retirement age, the measure of inflation used to calculate cost-of-living adjustments, or progressive indexing), thereby reducing future costs and creating new surpluses to prefund the retirements of a new generation. Reform is possible along multiple margins. Certainly, current levels of political polarization and the Republican Party's aversion to tax increases do not provide much room for optimism regarding the ability of Congress to forge a broad bipartisan reform coalition. But this would appear to be an issue that is quite separate from the vicissitudes of trust fund balances. Alternatively, Congress could simply change the underlying financial model to permit an infusion from, or reliance on, general revenues, replicating the function of Medicare's SMI trust fund.

Although the gross national debt is disaggregated into the debt held by the public and the intragovernmental debt, the distinction is less important than one might imagine. The trust fund balances are assets to the underlying programs, but they are simultaneously liabilities for the Treasury. When the expenditures of Social Security and Medicare exceed revenues, the Treasury needs to redeem the bonds it issued. As the federal government redeems the almost $3 trillion of obligations in the OASDI trust fund, it will have some important decisions to make. It can fund redemptions through tax increases, the diversion of spending from other programs, the issuance

of debt to the public, or some combination thereof (Patashnik 2000, 6). Given the strong opposition to tax increases and the persistent decline in the share of outlays devoted to discretionary spending, public borrowing will be the most likely response. Intergovernmental debt, in short, will be converted into debt held by the public, intensifying concerns over the looming fiscal crisis.

Conclusion

This article began by noting the three broad components in the postwar fiscal history of the United States: the growth in programmatic mandatory spending as a share of outlays, the changing composition of revenues, and the massive growth in the debt-to-GDP ratio that has occurred since the 1980s. The growth of mandatory spending should come as no surprise, given program design and demographic trends. Its dominance over discretionary spending, however, is partially a function of the revenue constraint. This constraint, in turn, was partially a product of the staunch opposition to increases in the individual and corporate income tax exhibited in the post-1980 decades and partially the growing share of revenues derived from earmarked social insurance taxes. While the accumulation of payroll receipts in the trust funds allowed the largest mandatory programs to exhibit remarkable stability, the changing composition of revenues placed ongoing pressure on the general fund, the fiscal backbone of discretionary spending. This has exacerbated the growth in the debt held by the public and created ongoing concerns about an imminent fiscal crisis—concerns that will only be intensified by future redemptions of trust fund surpluses.

As has been argued in this article, the current fiscal situation reflects, in no small part, critical decisions that were made in the formative moments of the modern welfare state. The decision to draw a distinction between social “insurance” and “relief,” the decision to fund the

former through “contributory” payroll taxes, and the decision to anchor the Social Security system in a fully funded Old-Age Reserve Account made sense given the political context. But the subsequent decisions to accelerate the provision of benefits, expand the generosity and coverage of the program, and suspend scheduled increases in the payroll tax constituted an abandonment of the original model. The decision to retain remnants of the original institutional architecture even when it no longer served the intended purpose has created unintended consequences, exacerbated by the decision, three decades later, to invoke the same distinctions (“insurance” versus “relief”) and a comparable financial model.

The inexorable growth in the national debt, the growing claim of interest payments, and the impending insolvency of the trust funds supporting the two largest entitlement programs will force fiscal reform on to the policy agenda. Congress will face difficult choices involving tax increases, benefit reductions, and structural changes to programs that have been essential to income and healthcare security in an aging population. While reform proposals have proliferated in recent years, each carry significant trade-offs that could compromise the adequacy of, and political support for, key programs. Given the high levels of partisan polarization and the intensity of conflict, the task of building a broad, bipartisan reform coalition will be difficult. Perhaps a first step on the path to reform will be to understand the extent to which the impending fiscal crisis is an artifact of decisions that were made at a formative moment in the development of the US welfare state.

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[1] All subsequent discussions of the debt in this piece will refer to the debt held by the public unless otherwise noted.
[2] The data for the Congressional Budget Office's long-term budget projections is available at https://www.cbo.gov/system/files/2022-07/57971-Data.xlsx.