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FEDERAL INCOME TAXES, AS A SHARE OF GDP, DROP TO LOWEST LEVEL SINCE 1942, ACCORDING TO FINAL BUDGET DATA

Erosion of income tax base drives other key budget developments

By Isaac Shapiro[1]

The final budget figures for fiscal year 2003 were released on October 20 by the Treasury Department. They indicate that income tax receipts (including receipts from both the individual and corporate income tax) equaled just 8.6 percent of the Gross Domestic Product. This is the lowest level of income tax collections, as a share of the economy, since 1942. The decline in income taxes as a share of the economy to a level last seen six decades ago helps explain several other key findings about the final budget tally.

- In 2003, *total* federal revenues as a share of the Gross Domestic Product dropped to 16.6 percent. The last time that total revenues as a share of the economy fell below 17 percent was in 1959, near the end of the Eisenhower Administration. (The Gross Domestic Product is the basic measure of the size of the U.S. economy.)

- Not only are income taxes at historically low levels relative to the size of the economy, they are also at historically low levels as a share of all federal revenues. In 2003, the share of federal revenues consisting of income taxes fell to its lowest level since 1941. Conversely, the share of federal revenues consisting of payroll taxes reached the highest level in the history of the tax system.

- The sizable federal deficit in 2003 of 3.5 percent of GDP is more directly a reflection of diminished revenues than of increased spending. While revenues as a share of GDP fell to their lowest level in 44 years, spending as a share of GDP was below its level in any year from 1980 to 1996, and far below its levels during the downturns of the early 1980s and early 1990s.

- The federal deficit would have been much larger in 2003 except for the fact that receipts going into the Social Security system exceeded Social Security expenditures. The "on-budget" deficit in 2003 — the government's measure that excludes consideration of Social Security receipts and expenditures — was 5.0 percent of the economy.

The fall in income taxes is explained to some degree by the economic slump, but other factors clearly are also at work, since revenues dropped to levels significantly below those seen in the wake of the deeper recessions of the mid-1970s and early 1980s. The other key factor is the large income tax cuts enacted since 2001. To illustrate:

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- Revenues dropped from 17.9 percent of GDP in fiscal year 2002 to 16.6 percent in fiscal year 2003, even though the overall economy grew over this period. The steep decline mostly reflects the larger tax cuts this year than last.

- In the absence of the tax cuts, income tax revenues in 2003 would still have been on the low side by post-World War II standards but would not have been close to the lowest level since 1942. Similarly, without the tax cuts, *total* revenues as a share of GDP would not have been close to the lowest level since 1959.

The degree to which income tax revenues return to their more traditional level as a share of GDP depends largely on whether the recent tax cuts are made permanent and whether sizable new tax cuts are enacted. If the tax cuts enacted since 2001 are extended through 2013, the revenue base will remain quite low by historic standards even if no new tax cuts are enacted. Over the next ten years, revenues as a share of the economy would average less than they averaged in the decades of the 1960s, 1970s, 1980s, and 1990s.

Key 2003 Figures in Historical Perspective

In 2003, several key federal revenue figures were at levels not seen in many decades. As a share of the economy:

- Income taxes fell to their lowest level since 1942.

- Individual income taxes dropped to lowest level since 1966.

- Corporate income taxes were at the lowest level since 1937, with the exception of 1983.

- Total federal revenues declined to their lowest level since 1959.

The decline in income tax receipts also led to a shift in the composition of federal revenues.

- The share of federal revenues consisting of income taxes was at the lowest level since 1941.

- The share of federal revenues consisting of payroll taxes rose to the highest level in the nation's history.

The Drop in Revenues

The decline in income tax revenues as a share of the economy to its lowest level in more than six decades reflects a drop in both individual and corporate tax receipts. In 2003:

- Federal individual income taxes equaled 7.4 percent of GDP. This is the lowest level since 1966.

- Corporate income taxes were just 1.2 percent of GDP. With the exception of the deep recession year of 1983, this is the lowest level since 1937. (A recent Center on Budget and Policy Priorities analysis discusses the fall in corporate income taxes in more detail.)[2]

The sharp decline in income tax collections — at a time when other revenue sources, such as payroll taxes, have remained stable — means that income taxes now contribute a smaller share of federal revenues overall. In 2003, the share of federal revenues that consisted of income taxes fell to its lowest level since 1941.

From their inception in the mid-1930s through 1986, payroll taxes as a share of the economy rose fairly steadily. Since 1986, payroll taxes have been a relatively constant share of the economy.[3] But with the recent decline in income tax revenues, payroll taxes have become a larger share of federal taxes. The net result: the share of federal revenues that consists of payroll taxes was larger in 2003 than at any other point in the nation's history.

In short, in assessing which taxes have contributed to the decline in revenues and the large increases in deficits, the answer is obvious: income taxes. Another way to grasp this is to look at the "on-budget deficit", which excludes the current surpluses in the Social Security trust funds. (About three-quarters of payroll taxes are used to fund Social Security; the remainder is dedicated to Medicare Hospital Insurance or Unemployment Insurance.)

- In 2003, on-budget receipts equaled 11.7 percent of GDP while on-budget expenditures equaled 16.7 percent of GDP, yielding an on-budget — or non-Social Security — deficit of 5.0 percent.

- For on-budget receipts and expenditures to have been in balance, receipts would have to have been 43 percent higher

The Contributions of Changes in Revenues and Changes in Spending to the Deficit

As the adjacent table indicates, compared to the deficits over the past three decades, the deficit in 2003 is a reflection of a decline in revenues, not an increase in spending. Not only are revenues as a share of the economy lower than in any other year since 1959, but they are well below the average level from 1970 to 2000.

What is Different about This Year?
The budget as a share of GDP

	2003	**Average 1970-2000**
Expenditures	20.1%	20.9%
Revenues	16.6%	18.3%
Deficits	3.5%	2.5%

Columns may not add due to rounding.

By contrast, the Treasury data indicate that federal expenditures equaled 20.1 percent of the economy in 2003. This is not an exceptionally high

[2] Joel Friedman, "The Decline of Corporate Income Tax Revenues," Center on Budget and Policy Priorities, October 16, 2003.

[3] In 2003, payroll taxes equaled 6.6 percent of the economy. From 1986 through 2003, payroll taxes have ranged between 6.5 percent and 6.9 percent of the economy.

level of spending as a share of the economy. To the contrary, it is below the 1970-2000 average, below *every* year from 1980 to 1996, and well below the levels during the downturns of the early 1980s and 1990s. In 1982-1983, spending averaged 23.3 percent of GDP; in 1991-1992, spending averaged 22.3 percent of GDP.

Moreover, while it is true that federal expenditures as a share of the economy have grown since their recent low in 2000, the majority of this increase reflects increased defense spending, including for the wars in Afghanistan and Iraq, and rising homeland security costs.

The Role of Income Tax Cuts

To some degree, these low revenue levels reflect the effects of weak economic growth. But these historically low levels of revenue collections also reflect the impact of tax cuts enacted in the past few years. The major tax cuts enacted in 2001, 2002, and 2003 reduced revenues by $166 billion in 2003, according to the official cost estimates by the Joint Committee on Taxation. Nearly all of these reductions were in income taxes.

Without those tax cuts, income tax revenues would have equaled 10.1 percent of the economy in 2003. This would still have been below its average for the period since the early 1940s but would not be close to the lowest level since 1942. Similarly, without those tax cuts, overall revenues as a percent of GDP would not be close to the lowest level in 44 years.

The effects of the tax cuts enacted in recent years have not yet been fully played out, since the tax cuts have yet to take full effect. The tax-cut legislation enacted over the past three years will reduce revenues by $270 billion in 2004, substantially more than the $166 billion in revenue reductions the legislation contained for 2003. As a result, it appears that in 2004, revenues will not rebound as a share of the economy. Current projections are that total revenues will remain at about the same level as a share of the economy in 2004 as in 2003 and will continue to be lower than in any other year since 1959; similarly, in 2004, income tax revenues as a share of the economy will continue to be lower than in any other year since 1942. Only if the economy rebounds significantly more than CBO expects will revenues rise noticeably as a share of the economy.

Looking beyond 2004, several factors will determine just how low the level of revenues remains as a share of the economy. One factor is the amount of economic growth that occurs and the distribution of that growth. Another major factor, however, is whether the numerous tax cuts now scheduled to expire between 2004 and 2010 actually are allowed to end or are extended. The Administration and key Republican leaders in Congress have made clear they intend to extend most of these provisions. If they are extended, revenues as a share of the economy will remain at exceptionally low levels.

- A study by two economists from the Brookings Institution found that the cost of extending all tax cuts set to expire between now and 2010 will amount to 2.4 percent of the economy in 2013.[4]

[4] William G. Gale and Peter R. Orszag, "Sunsets in the Tax Code," *TaxNotes*, June 9, 2003, pp. 1553-1561.

- A joint study just issued by the Center on Budget and Policy Priorities, the Committee for Economic Development, and the Concord Coalition found that if the recent tax cuts are extended and Alternative Minimum Tax relief scheduled to expire in 2004 is indexed to inflation, revenues will average 17.2 percent of GDP from 2004 through 2013.[5] This level is lower than the average level of revenues as a share of GDP in the decades of the 1960s, the 1970s, the 1980s, and the 1990s, and equivalent to the average for the 1950s. It may be noted that the 1950s were a period in which Medicare, Medicaid, most federal aid to education, most environmental protection and clean-up programs, and various other federal endeavors did not yet exist.

  If the tax cuts are not extended, revenues as a share of GDP would be projected to return to its traditional level.

Still another factor that will affect revenue levels in 2004 and beyond is whether further tax cuts are enacted. Both the House and Senate have passed several new tax-cut measures in recent months, with the House tax cuts having a total ten-year cost of $260 billion.[6] In addition, the Chairman of the House Ways and Means Committee recently introduced a measure that contains substantial new reductions in corporate income taxes, and the Ways and Means Committee has passed pension-related tax cuts; in combination, the corporate and pension provisions cost more than $100 billion over ten years. In short, while it is unclear how many of these bills might be enacted, significant interest remains in cutting taxes further.

Conclusion

The exceptionally low level to which income tax receipts have already fallen, in conjunction with the looming deficits that lie ahead, should cause policymakers to pause before enacting new income tax cuts or extending current ones without offsetting their costs. The drop in revenues already explains much of the dramatic deterioration in the nation's fiscal position and the increase in the deficit. Revenues have now fallen to such low levels as to threaten the adequacy of the nation's revenue base, especially with the retirement of the baby-boom generation rapidly approaching. Consideration may, in fact, need to be given to revenue-raising measures once the nation has clearly pulled out of the current economic slump.

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[5] Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities, *Mid-term and Long-term Deficit Projections*, September 29, 2003.

[6] The $260 billion figure only includes the drop in tax collections that would result from these tax bills; it does not include the $70 billion in interest costs that would result from the House-passed bills. The House bills include health-related tax cuts; expansion of the child tax credit; energy-related tax cuts; and charitable giving incentives. See Joel Friedman, "More Fiscally Irresponsible Tax Cuts This Fall," Center on Budget and Policy Priorities, September 30, 2003.

Appendix Table 1. Federal Income Tax Receipts as a Share of Gross Domestic Product, 1942-2003

Fiscal Year	Corporate	Individual	Total Income Tax	Fiscal Year	Corporate	Individual	Total Income Tax
1942	3.3%	2.3%	5.6%	1973	2.8%	7.9%	10.7%
1943	5.3	3.6	8.9	1974	2.7	8.2	10.9
1944	7.1	9.4	16.5	1975	2.6	7.8	10.4
1945	7.2	8.3	15.5	1976	2.4	7.6	10.0
1946	5.3	7.2	12.5	1977	2.8	8.0	10.8
1947	3.7	7.6	11.3	1978	2.7	8.2	10.9
1948	3.8	7.5	11.3	1979	2.6	8.7	11.3
1949	4.1	5.7	9.8	1980	2.4	8.9	11.3
1950	3.8	5.8	9.6	1981	2.0	9.3	11.3
1951	4.4	6.7	11.1	1982	1.5	9.2	10.7
1952	6.1	8.0	14.1	1983	1.1	8.4	9.5
1953	5.7	8.0	13.7	1984	1.5	7.8	9.3
1954	5.6	7.8	13.4	1985	1.5	8.1	9.6
1955	4.5	7.3	11.8	1986	1.4	7.9	9.3
1956	4.9	7.5	12.4	1987	1.8	8.4	10.2
1957	4.7	7.9	12.6	1988	1.9	8.0	9.9
1958	4.4	7.5	11.9	1989	1.9	8.2	10.1
1959	3.5	7.5	11.0	1990	1.6	8.1	9.7
1960	4.1	7.8	11.9	1991	1.7	7.9	9.6
1961	3.9	7.8	11.7	1992	1.6	7.7	9.3
1962	3.6	8.0	11.6	1993	1.8	7.8	9.6
1963	3.6	7.9	11.5	1994	2.0	7.8	9.8
1964	3.7	7.6	11.3	1995	2.1	8.1	10.2
1965	3.7	7.1	10.8	1996	2.2	8.5	10.7
1966	4.0	7.4	11.4	1997	2.2	9.0	11.2
1967	4.2	7.6	11.8	1998	2.2	9.6	11.8
1968	3.3	7.9	11.2	1999	2.0	9.6	11.6
1969	3.9	9.2	13.1	2000	2.1	10.3	12.4
1970	3.2	8.9	12.1	2001	1.5	9.9	11.4
1971	2.5	8.0	10.5	2002	1.4	8.3	9.7
1972	2.7	8.0	10.7	2003	1.2	7.4	8.6

Source: Office of Management and Budget and the U.S. Department of Treasury.

Appendix Table 2. Federal Receipts as a Share of Gross Domestic Product, 1951-2003

Fiscal Year		Fiscal Year	
1951	16.1%	1978	18.0%
1952	19.0	1979	18.5
1953	18.6	1980	18.9
1954	18.4	1981	19.6
1955	16.6	1982	19.1
1956	17.4	1983	17.5
1957	17.7	1984	17.4
1958	17.3	1985	17.7
1959	16.1	1986	17.5
1960	17.8	1987	18.4
1961	17.7	1988	18.1
1962	17.5	1989	18.3
1963	17.8	1990	18.0
1964	17.6	1991	17.8
1965	17.0	1992	17.5
1966	17.3	1993	17.6
1967	18.3	1994	18.1
1968	17.6	1995	18.5
1969	19.7	1996	18.9
1970	19.0	1997	19.3
1971	17.3	1998	19.9
1972	17.5	1999	20.0
1973	17.6	2000	20.8
1974	18.3	2001	19.9
1975	17.9	2002	17.9
1976	17.2	2003	16.6
1977	18.0		

Source: The Office of Management and Budget and the U.S. Department of Treasury.