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January 15, 2004

TOTAL REVENUES FROM ALL LEVELS OF GOVERNMENT DROP TO LOWEST SHARE OF ECONOMY SINCE 1968

Government Spending at Lower Share of GDP Than in All Years from 1980-1996

By Isaac Shapiro and Nicholas Johnson

In recent years, the overall fiscal position of the government — reflecting federal, state, and local governments combined — has shifted from one of surpluses to one of substantial deficits. Just-released government data show the principal reason for this shift is that revenue collections have shrunk markedly. Combined federal, state, and local revenues fell in fiscal year 2003 to their lowest level, measured as a share of the economy, since 1968.

Highlights

In fiscal year 2003, as a share of the economy:

- Total government revenues (federal, state, and local combined) declined to their lowest level since 1968.
- Total federal revenues declined to their lowest level since 1959.
- Federal income taxes fell to their lowest level since 1942.
- State and local revenues were lower than since 1988.
- Total government spending was not unusually high; it was lower than in every year from 1980 through 1996.

Each year, the Office of Management and Budget issues data on total government receipts and expenditures (based on combined federal, state, and local data), including data on receipts and expenditures as a share of the economy, the standard measure for tracking changes in receipts and expenditures over time. OMB last issued these data in February 2003. Recently, the Department of Commerce issued new data taking these data through the end of the federal fiscal year 2003, which ended September 30.[1] The data show that in fiscal year 2003:

- Combined federal, state, and local revenues equaled 27 percent of the Gross Domestic Product, which was the lowest level of revenue collections — as a share of the economy — since 1968. (The Gross Domestic Product is the basic measure of the size of the U.S. economy.)
- The decline in government receipts has been sharpest at the federal level. Measured as a share of the economy, total federal revenues fell to their lowest level since 1959, with federal

[1] These Commerce Department data provide state revenue and spending figures for fiscal year 2003. The Commerce Department data also include revised figures for earlier years.

income tax revenues (counting both individual and corporate income tax revenues) falling to their lowest level since 1942.

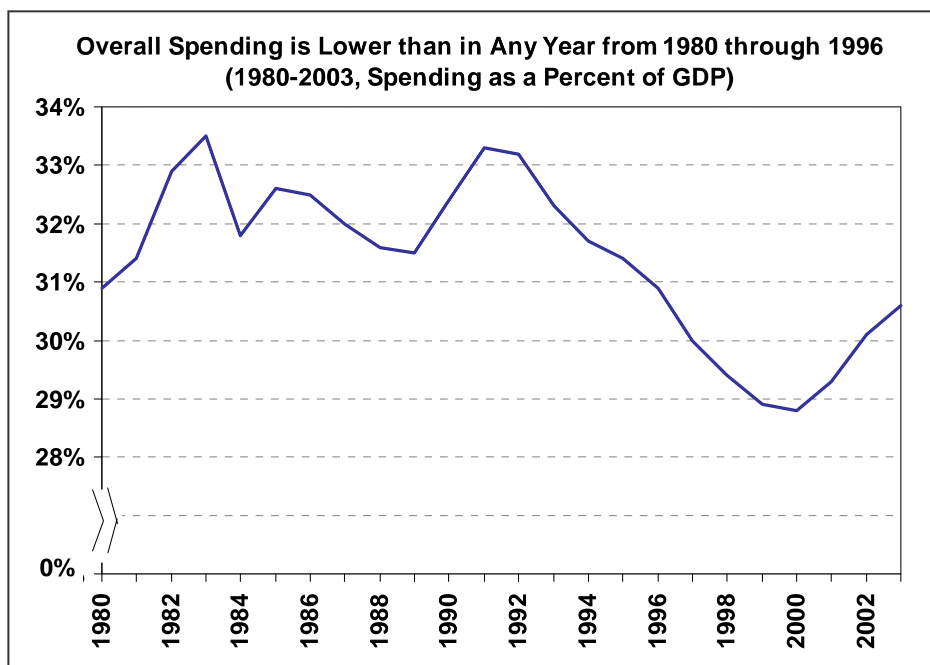
- State and local government revenues declined as well, dropping to their lowest level, as a share of the economy, since 1988.

- With federal revenues declining more rapidly than state and local revenues, the share of total government revenues collected by the federal government fell to its lowest level on record. These data are available back to 1948.

The combined budget deficit for all levels of government equaled 3.6 percent of GDP in fiscal year 2003. The emergence of this sizable deficit is more a reflection of diminished revenues than of increased spending. As just noted, total revenues collected by all levels of government fell to their lowest level in 35 years, as a share of GDP. Spending, by contrast, is not at unusually high levels.

- Total spending on all levels of government, measured as a share of the economy, was lower in 2003 than in every year from 1980 through 1996. Spending just by the *federal* government was lower, as a share of the economy, than in any year from 1975 through 1996.

- Total government spending is modest now for a period affected by an economic downturn. As a share of the economy, it is 2.6 percentage points below its levels during the downturns of the early 1980s and early 1990s. If the nation had devoted the same share of the economy to government expenditures in 2003 as it did, on average, during the early 1980s and early 1990s, expenditures would have been $285 billion higher last year.



The fall in government revenues is partly explained by the economic slump. Other factors clearly also are at work, however, since revenues dropped to levels significantly below those seen in the wake of the other economic downturns of the past three decades. The most important other factor is the large federal income tax cuts enacted since 2001. In the absence of the federal income tax cuts, total government revenues in 2003 as a share of GDP would not have been anywhere close to their lowest level since 1968.

If the recent tax cuts are made permanent, the low level of federal revenues will persist, although federal revenues will be somewhat higher after the economy recovers than they were in 2003. Continued large deficits are likely to diminish long-term economic growth and to leave the nation in weaker shape to respond to the coming retirement of the baby-boom generation.

While the federal government was cutting taxes substantially in recent years, more than half of the states were raising taxes. Both the federal tax cuts and the majority of the state tax increases were *tilted in favor of high-income taxpayers*. The federal tax cuts were of far greater benefit to high-income taxpayers than to other taxpayers. Most of the state and local tax increases that occurred, though relatively modest in size, hit middle- and low-income taxpayers harder than high-income taxpayers.

The state and local tax increases enacted in the last few years are much smaller than the tax cuts that states instituted in the late 1990s. The recent state and local tax increases also are considerably smaller than the state and local budget cuts instituted in the past few years. As other reports by the Center on Budget and Policy Priorities explain, large numbers of states have cut eligibility for health insurance in the past two years, with 1.2 million to 1.6 million low-income people (including about 500,000 low-income children) losing health care coverage. In addition, many states have reduced child care aid and decreased support for K-12 and higher education, among other budget reductions.[2]

Finally, a just-released report by the International Monetary Fund on the U.S. fiscal situation received substantial coverage for its conclusion that the large U.S. budget deficit and trade imbalance pose a threat to the stability of the world's economy.[3] As the text box on the next page indicates, the IMF also found that the shift in the U.S. fiscal balance reflects changes both at the federal level and at the state and local level, and that this shift could weaken the U.S. economy over the long term, and has made the country less well-equipped to respond to the upcoming retirement of baby boomers.

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[2] Leighton Ku and Sashi Nimalendran, "Losing Out," Center on Budget and Policy Priorities, December 2003; Elizabeth C. McNichol and Jennifer Schiess, "Fiscal Crisis is Shrinking State Budgets, Center on Budget and Policy Priorities, October 2003.

[3] Elizabeth Becker and Edmund L. Andrews, "IMF Says Rise in U.S. Debts Is Threat to World's Economy," *The New York Times*, January 8, 2004, page A1.

IMF Findings on the Effects of the Large, Combined Government Deficit

On January 7, 2004, the International Monetary Fund released a report entitled *U.S. Fiscal Policies and Priorities for Long-Run Sustainability*. This report has received widespread attention. It begins with the following three paragraphs.

> "U.S. government finances have experienced a remarkable turnaround in recent years. Within only a few years, hard-won gains of the previous decade have been lost and, instead of budget surpluses, deficits are again projected as far as the eye can see. The deterioration has not been restricted to the federal budget but has also taken place at the state and local government levels. As a result, the U.S. general government deficit is now among the highest in the industrialized world, and public debt levels are approaching those in other major industrial countries.
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> Although fiscal policies have undoubtedly provided valuable support to the recovery so far, the return to large deficits raises two interrelated concerns. First, with budget projections showing large federal fiscal deficits over the next decade, the recent emphasis on cutting taxes, boosting defense and security outlays, and spurring an economic recovery may come at the eventual cost of upward pressure on interest rates, a crowding out of private investment, and an erosion of longer-term U.S. productivity growth.
>
> Second, the evaporation of fiscal surpluses has left the budget even less well prepared to cope with the retirement of the baby boom generation, which will begin later this decade and place massive pressure on the Social Security and Medicare systems. Without the cushion provided by earlier surpluses, there is less time to address these programs' underlying insolvency before government deficits and debt begin to increase unsustainably, making more urgent the need for meaningful reform."

The Drop in Federal Revenues

In 2003, federal revenues declined, as a share of the economy, to their lowest level since 1959. (Unless noted otherwise, the figures used in this analysis are for federal fiscal years, which cover 12-month periods ending September 30.) Yet 1959 was a time when Medicare, Medicaid, most federal aid to education, most environmental protection and clean-up programs, and various other federal endeavors did not exist.

It is this drop in federal revenues as a share of the economy to the lowest level since the Eisenhower Administration that is most responsible for the drop in overall government revenues to a level not seen since 1968. The share of *total* government revenues that consists of *federal* revenues fell to its lowest level on record, with data back to 1948.

In turn, the drop in federal revenues reflects erosion in federal *income* taxes. In 2003:

- Combining individual and corporate income taxes, total federal income taxes equaled 8.5 percent of the economy, the smallest share since 1942. Both

individual and corporate income taxes have declined to exceptionally low levels.[4] The other major source of federal revenues, payroll taxes, has been a relatively stable share of the economy since 1988, after rising for several decades.

- The share of total government revenues that consists of federal *income tax* revenue has fallen markedly. From 1948 to 1957, federal income taxes typically accounted for more than half of all government revenues; in 2003, they were at their lowest level on record and accounted for slightly less than a third of government revenues.

In short, in assessing which taxes have contributed most to the decline in revenues and the large increases in deficits, the answer is: federal income taxes.

The low level of income tax revenues partly reflects the effects of weak economic growth. But it also reflects the impact of tax cuts enacted in the past few years. The major tax cuts enacted in 2001, 2002, and 2003 reduced revenues by $172 billion in 2003, according to the official cost estimates of the Joint Committee on Taxation. Without these tax cuts, federal income tax revenues would have equaled 10.1 percent of the economy in 2003, rather than their actual level of 8.5 percent, and overall revenues as a share of GDP would not have been anywhere close to the lowest level since 1968.

Trends in State and Local Revenues

Some 30 states have enacted some type of tax increase since 2001, and roughly half of these tax increases were in effect throughout the 2003 fiscal year. Even with these tax increases, state and local revenues as a share of the economy were lower in 2003 than in every year since 1988. This decline reflects both the weak economy and substantial state tax cuts enacted in the mid and late 1990s, which were more than twice the size the recent state tax increases.[5]

While state and local revenues consist mostly of taxes (including property, sales, and income taxes), they also include revenues from *non*-tax items, such as fees, donations, and legal settlements. Altogether, state and local revenues equaled an estimated 10.6 percent of GDP in 2003.[6]

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[4] Federal individual income taxes equaled 7.3 percent of GDP in 2003, the lowest level since 1966. Federal corporate income taxes equaled 1.2 percent of GDP in 2003. 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 detail: Joel Friedman, "The Decline of Corporate Income Tax Revenues," Center on Budget and Policy Priorities, October 16, 2003.

[5] See Nicholas Johnson, Jennifer Schiess, and Joseph Llobrera, "State Revenues Have Fallen Dramatically: Tax Increases So Far Have Failed to Fill the Gap," Center on Budget and Policy Priorities, October 2003.

[6] Following OMB practice, these figures are drawn from the National Income and Product Accounts and exclude revenue received from the federal government. State and local *taxes* (as distinguished from state and local *revenues*, which include money from non-tax revenue sources), equaled 8.8 percent of GDP in 2003, which was the lowest level since 1985.

How Changes in Revenues and Changes in Spending Have Contributed to Deficits

What is Different About 2003?
Total Government Expenditures, Revenues, and Deficits as a Share of GDP

	Average 1980-2002	2003
Expenditures	31.4%	30.6%
Revenues	29.1%	27.0%
Deficits	2.3%	3.6%

As the adjacent table indicates, the large combined government deficit in 2003 is a reflection of a decline in revenues, not an increase in spending.[7] In fact, expenditures in 2003, measured as a share of the economy, were relatively low in historical terms.

Total government expenditures equaled 30.6 percent of the economy in 2003, which was below the average (as a share of the economy) for the 1980-2002 period. It also is below the level of expenditures as a share of the economy in every year from 1980 to 1996, and well below the levels of expenditures during the downturns of the early 1980s and 1990s. In 1982-1983 and 1991-1992, total government expenditures averaged 33.2 percent of GDP — 2.6 percentage points higher than in 2003. (See Appendix Tables I and II for year-by-year data on government expenditures and revenues as a share of the economy.)

The drop in spending as a share of the economy — compared to prior years in general and previous economic downturns in particular — has been most pronounced at the federal level.

- Federal spending in 2003 was lower as a share of the economy than in every year from 1975 through 1996. Moreover at 19.9 percent of GDP in 2003, it was 2.3 percentage points below its average of 22.2 percent of GDP in 1991-1992, during the previous economic downturn.

- State and local spending in 2003, at 10.7 percent of GDP, was down slightly from the 1991-1992 level of 11.0 percent.

Federal Tax Cuts Helped High-Income Households the Most; Modest State Tax Increases Affected Them the Least

The income tax cuts that drove down federal revenue levels were of greatest benefit to high-income households. According to data from the Urban Institute/Brookings Institution Tax Policy Center, the large individual income tax cuts enacted in 2001 and 2003 have had the following effects:

- The average tax cut for the top one percent of households for tax year 2003 will be $26,300. For those with incomes above $1 million, the average tax cut will be $113,000.

- By contrast, the middle fifth of households will receive a much more modest average tax cut of $676 for 2003.

[7] The federal deficit in 2003 equaled 3.5 percent of GDP and was covered by federal borrowing. State-local deficits totaled 0.1 percent of GDP. Most state and local governments are required to balance their budgets but often are able to do so in part by drawing down reserve funds, issuing bonds, or taking similar actions that do not serve to reduce deficits as defined in the NIPA accounts.

- The after-tax income of millionaires will increase by an average of 5.4 percent in 2003, due to the tax cuts. This is more than double the average percentage increase in after-tax income that the middle fifth of households will secure from the tax cuts.

While middle-class households were gaining less than high-income households from the federal tax cuts, they were being hit harder by state and local tax increases. The majority of the state tax increases adopted since late 2001 — 54 percent of them — have consisted of increases in regressive taxes (that is, of taxes that consume a larger share of the income of low- and middle-income households than of high-income households).

In revenue terms, the recently enacted state tax increases have offset a portion of the tax reductions that states enacted in the late 1990s. But the pattern of the state tax cuts of the 1990s and the recent tax increases are very different. Although 54 percent of the recent state tax increases were in regressive taxes, only 19 percent of the state tax cuts of the late 1990s were made in regressive taxes. In other words, when states chose to cut taxes in the 1990s, they largely made cuts in progressive taxes that disproportionately affect high-income households, but when they chose to raise taxes (which they did to a lesser degree) in recent years, they largely increased those taxes that are among the least burdensome to high-income households.

In addition, to the extent that *local* governments are raising taxes, these increases are occurring almost entirely in regressive taxes. Most local governments do not have progressive taxes at their disposal.

The combination of federal tax cuts most beneficial to the wealthy and state and local tax increases most burdensome to those with low or modest incomes is likely leading to an overall shift in tax burdens to low- and middle-income households.

Down the Road

The effects of the federal tax cuts enacted in recent years have not yet fully played out, since some of the tax cuts have yet to take full effect. The tax-cut legislation enacted over the past three years will reduce revenues by $264 billion in 2004, substantially more than the $172 billion in revenue reductions the legislation produced for 2003. As a result, federal revenues are not likely to rebound much, if at all, in 2004 as a share of the economy.

Looking beyond 2004, several factors will determine just how low the level of federal revenues remains as a share of the economy. Two factors are the amount of economic growth that occurs and the distribution of that growth. Another major factor is whether the numerous tax cuts now scheduled to expire between 2004 and 2010 actually are allowed to end or are extended. The Bush Administration and key Republican leaders in Congress have made clear their intent to extend most of these provisions. If these tax measures are extended, revenues as a share of the economy will remain at unusually low levels.[8]

[8] 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 federal tax cuts are extended and Alternative Minimum Tax relief scheduled to expire in 2004 is indexed to inflation, federal revenues will average 17.2 percent of GDP from 2004 through 2013. This level is lower than the average level of federal revenues as a share of GDP in the decades of the

Another factor that will affect federal revenue levels in 2004 and beyond is whether further tax cuts are enacted. There is significant interest in additional tax cuts, with the White House expected to offer new tax cuts related to savings and health care as part of its 2004 budget.

At the state and local level, tax increases enacted in 2003 generally will have their first full fiscal effect in 2004, slightly increasing revenues in that year. A continued economic recovery will increase revenues as well. But the overall increase likely will be modest. State and local revenues are not as responsive to economic growth as federal revenues are. States and localities rely less on income taxes, which tend to grow substantially as the economy expands, than the federal government does. Further, some of the state tax increases enacted in recent years are scheduled to expire in the next two or three years.

The exceptionally low level to which government receipts have fallen, in conjunction with the looming deficits that lie ahead, should cause policymakers at all levels of government to pause before enacting new tax cuts or extending current ones without offsetting their costs. At a time when the retirement of the baby-boom generation is rapidly approaching, revenues have fallen to such low levels as to threaten the adequacy of the nation's revenue base. At both the federal and state levels, consideration may, in fact, need to be given to revenue-raising measures as the nation pulls out of the current labor-market slump. As the Committee for Economic Development put it in a respected report issued in the spring of 2003 that called for both revenue increases and expenditure restraint, "it is extremely unlikely that the long-term budget problem can be solved without additional revenues."[9]

On the spending side, spending as a share of the economy already is lower than throughout the 1980-1996 period, and to the degree that continued economic growth leads to rising incomes and less unemployment and that expenditures in Iraq begin to decline, spending pressures will abate over the next few years. Nonetheless, it is increasingly being claimed that "runaway" government spending is the main culprit behind the deterioration in the fiscal picture. This report provides further evidence that such claims are not accurate.[10]

Over the longer term, however, the retirement of baby boomers, along with continued growth in health care costs, will lead to substantial spending pressures. As the Committee for Economic Development report pointed out, in the long term, spending restraint also is required.

1960s, the 1970s, the 1980s, and the 1990s, and is equivalent to the average for the 1950s. See *Mid-term and Long-term Deficit Projections*, September 29, 2003.

[9] Committee for Economic Development (CED), *Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America* March 2003.

[10] At the national level, a drumbeat of criticisms regarding recent growth in domestic spending has been driven by recent claims by the Heritage Foundation and others that federal spending is exceptionally high and that domestic spending has been growing unusually rapidly. The problems with the Heritage claims are discussed in Robert Greenstein, *et. al.* "Is Domestic Spending Exploding," Center on Budget and Policy Priorities, January 7, 2003.

Appendix 1. Government Revenues as a Share of the Economy

Fiscal Year	State and Local	Federal	Total Government	Fiscal Year	State and Local	Federal	Total Government
1948	5.5%	16.2%	21.7%	1976	10.0%	17.1%	27.2%
1949	5.8%	14.5%	20.3%	1977	10.0%	18.0%	28.0%
1950	6.3%	14.4%	20.7%	1978	9.8%	18.0%	27.8%
1951	6.0%	16.1%	22.1%	1979	9.4%	18.5%	28.0%
1952	5.9%	19.0%	24.9%	1980	9.5%	19.0%	28.5%
1953	6.0%	18.7%	24.7%	1981	9.5%	19.6%	29.1%
1954	6.3%	18.5%	24.8%	1982	9.8%	19.2%	28.9%
1955	6.5%	16.5%	23.0%	1983	10.0%	17.4%	27.5%
1956	6.7%	17.5%	24.1%	1984	10.2%	17.3%	27.5%
1957	6.9%	17.7%	24.6%	1985	10.4%	17.7%	28.1%
1958	7.1%	17.3%	24.4%	1986	10.6%	17.5%	28.0%
1959	7.2%	16.2%	23.3%	1987	10.7%	18.4%	29.1%
1960	7.5%	17.8%	25.3%	1988	10.6%	18.1%	28.8%
1961	7.9%	17.8%	25.7%	1989	10.8%	18.3%	29.1%
1962	8.0%	17.6%	25.5%	1990	10.7%	18.0%	28.7%
1963	8.1%	17.8%	25.9%	1991	10.9%	17.8%	28.7%
1964	8.2%	17.6%	25.7%	1992	11.0%	17.5%	28.5%
1965	8.3%	17.0%	25.3%	1993	10.9%	17.5%	28.4%
1966	8.2%	17.3%	25.5%	1994	10.9%	18.1%	28.9%
1967	8.3%	18.4%	26.7%	1995	10.9%	18.5%	29.3%
1968	8.7%	17.6%	26.3%	1996	10.9%	18.9%	29.8%
1969	9.0%	19.7%	28.7%	1997	10.8%	19.3%	30.1%
1970	9.5%	19.0%	28.5%	1998	10.8%	20.0%	30.8%
1971	9.8%	17.3%	27.1%	1999	10.8%	20.0%	30.9%
1972	10.1%	17.6%	27.7%	2000	10.9%	20.9%	31.8%
1973	10.2%	17.6%	27.8%	2001	11.0%	19.8%	30.8%
1974	10.1%	18.3%	28.4%	2002	10.7%	17.9%	28.6%
1975	10.1%	17.9%	28.0%	2003	10.6%	16.5%	27.0%

Appendix 2. Government Expenditures as a Share of the Economy							
Fiscal Year	State and Local	Federal	Total Government	Fiscal Year	State and Local	Federal	Total Government
1948	5.1%	11.6%	16.7%	1976	9.7%	21.4%	31.1%
1949	5.3%	14.3%	19.6%	1977	9.4%	20.7%	30.1%
1950	5.8%	15.6%	21.4%	1978	9.0%	20.7%	29.7%
1951	5.3%	14.2%	19.5%	1979	8.9%	20.1%	29.0%
1952	5.2%	19.4%	24.6%	1980	9.2%	21.7%	30.9%
1953	5.1%	20.4%	25.5%	1981	9.2%	22.2%	31.4%
1954	5.4%	18.8%	24.2%	1982	9.8%	23.1%	32.9%
1955	5.7%	17.3%	23.0%	1983	10.0%	23.5%	33.5%
1956	5.7%	16.5%	22.2%	1984	9.7%	22.1%	31.8%
1957	5.9%	17.0%	22.9%	1985	9.8%	22.8%	32.6%
1958	6.4%	17.9%	24.3%	1986	10.1%	22.5%	32.5%
1959	6.5%	18.8%	25.3%	1987	10.4%	21.6%	32.0%
1960	6.7%	17.8%	24.4%	1988	10.3%	21.2%	31.6%
1961	7.1%	18.4%	25.6%	1989	10.3%	21.2%	31.5%
1962	7.1%	18.8%	26.0%	1990	10.6%	21.8%	32.4%
1963	7.2%	18.6%	25.7%	1991	11.0%	22.3%	33.3%
1964	7.2%	18.5%	25.7%	1992	11.0%	22.1%	33.2%
1965	7.4%	17.2%	24.6%	1993	10.9%	21.4%	32.3%
1966	7.2%	17.8%	25.0%	1994	10.7%	21.0%	31.7%
1967	7.4%	19.4%	26.9%	1995	10.8%	20.7%	31.4%
1968	7.9%	20.5%	28.4%	1996	10.6%	20.3%	30.9%
1969	8.2%	19.4%	27.6%	1997	10.4%	19.6%	30.0%
1970	8.7%	19.3%	28.0%	1998	10.3%	19.2%	29.4%
1971	9.2%	19.5%	28.7%	1999	10.3%	18.6%	28.9%
1972	9.2%	19.6%	28.8%	2000	10.4%	18.4%	28.8%
1973	8.8%	18.7%	27.6%	2001	10.7%	18.6%	29.3%
1974	9.2%	18.7%	27.9%	2002	10.8%	19.4%	30.1%
1975	9.8%	21.3%	31.1%	2003	10.7%	19.9%	30.6%