

Revenues: Which Ones Really Grew?

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Taxpayers often rebel against paying taxes, and politicians often respond to that rebellion by promising to reduce taxes if elected. Usually the rebellion is against federal taxes—in particular, the federal individual income tax—and is fed by analyses that indicate that taxes, by some measures, have hit all-time highs. Interestingly, however, the sources of revenue growth are misunderstood. Over the half century since World War II—that is, during the entire lives of most taxpayers alive today, revenues have grown at the state and local, not federal, level. Tax protests seem to center themselves on the largest and most visible of taxes, not those that are growing the most.

In [Figure 1](#), we show growth in revenues as a percentage of GDP from 1902 to 1993. In the first decades of this century, the federal government is small relative to state and local governments. Reflecting in part an increase in demand for government services, federal revenues more than double as a percent of the national economy from the beginning of the century up to the early Depression years. During this period the federal government has one big upswing in World War I, but then reduces its take on the national pie soon thereafter. During the Depression, federal revenues increase as a percentage of GDP, partly because GDP is falling. Still, states and localities remain the dominant collectors of money.

With World War II, of course, all this turns around. The federal government dramatically increases the share of the national pie that it will collect, largely through the individual and corporate income taxes. States and localities are quickly usurped, and there is a massive shift of power to Washington.

After World War II, the federal government moves initially to what might be viewed as a long holding pattern. It returns only a portion of the additional revenues it has been collecting, reacquires a good deal of even that tax cut during the Korean War, and then continues to collect about 20 percent of GDP ever since. The federal individual income tax maintains its status as the largest of all revenue sources and, in that role, becomes vulnerable to most of the protests against the tax system. Not only is it the largest source, however, it is also one of the most visible, as all payers of the tax must file individual income tax returns at the end of the year.

Despite many legislated tax cuts, bracket creep due to inflation and real growth in the economy keeps raising tax rates back up again. Overall, the federal individual income tax performs much like total federal revenues in remaining a relatively constant portion of GDP for the decades since the Korean War. Even the Reagan tax cuts in the early 1980s show up only as a modest blip on the graph, restoring individual income taxes to the level applying in 1976.

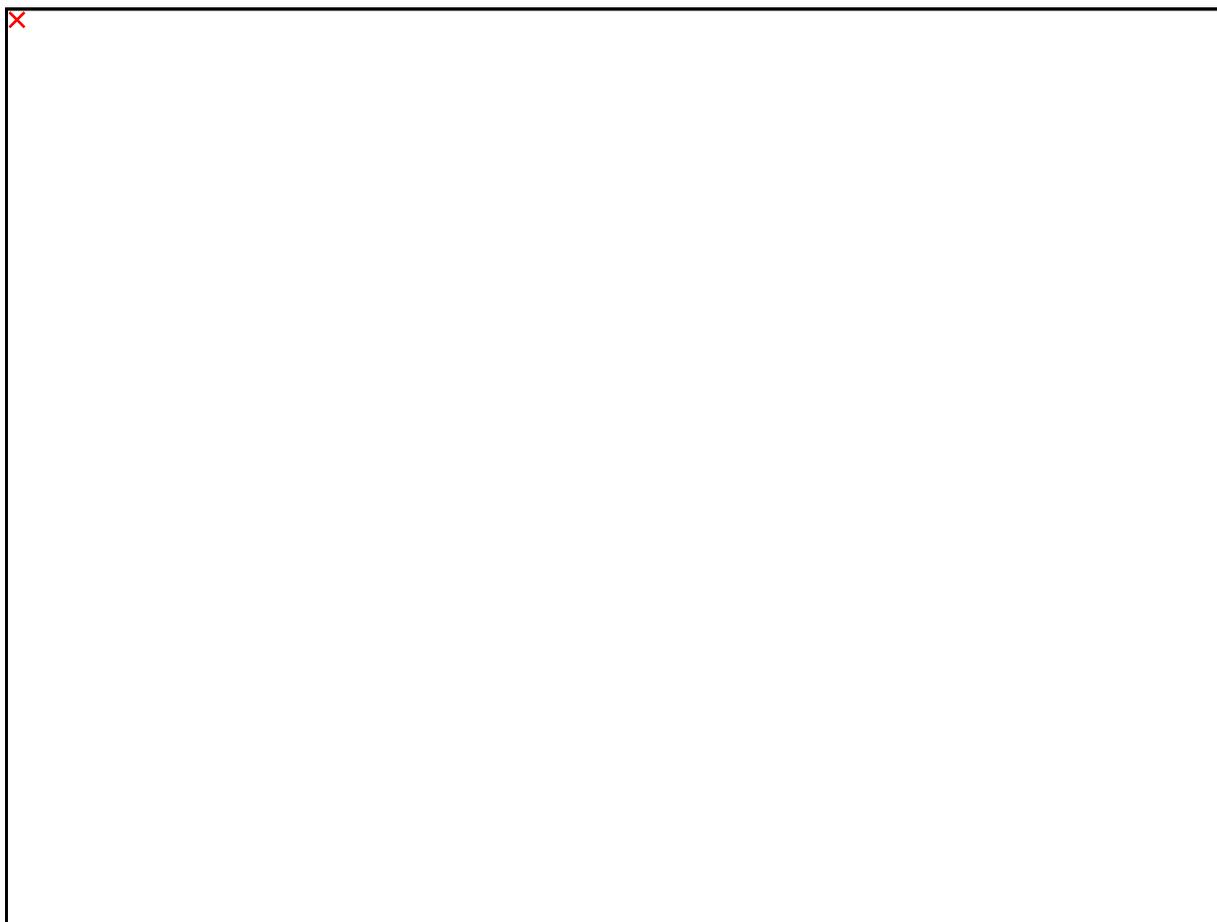
The federal government's primary means of increasing taxes throughout the postwar era is the social security tax. Although never the largest single revenue source, it eventually becomes the largest tax paid by most taxpayers, at least if we ascribe to them the cost of the employer portion of the tax paid on their behalf. Today most workers will pay a 15.3 percent social security tax rate on all earnings and a 15.0 percent individual income tax rate only on earnings in excess of an exempt amount, as determined by personal exemptions and other allowances. Only a minority of taxpayers pay an individual income tax in excess of 15.0 percent on any income. By the same token, except for the self-employed and some of those with multiple jobs and higher earnings, individuals do not file social security tax returns. Many are only vaguely familiar with the employee tax rate and even less knowledgeable about the employer tax rate paid on their behalf.

The social security tax, however, is still more transparent to many taxpayers than are other sources of federal revenues—primarily excise taxes and corporate income taxes. These latter sources, however, fell in importance throughout much of the postwar period for a variety of reasons. Corporate profits decline as a percentage of GDP, and excise taxes erode in importance as they are often stated in nominal terms and unadjusted for inflation. Also, the excise tax base does not grow with the economy as the nation shifts more toward untaxed services and away from taxed goods.

Perhaps the most interesting, seldom-noted trend is the steady growth of state and local revenues after World War II. Property taxes had been the dominant source of revenues for all levels of government up until the Depression, but they never recover their preeminent role. Instead, states and localities raise additional revenues after World War II in all sorts of ways. Individual income taxes are adopted by most states and then are allowed to grow, in no small part through steady bracket creep due to inflation and real income growth. Sales taxes also grow in importance, both through adoption of general sales taxes by more states and through legislated increases in sales tax rates. States and localities also adopt corporate income taxes and raise user charges and fees. Figure 1 includes many of those charges and fees but excludes such charges as those paid to utilities and to liquor stores. (Other sources, such as the Bureau of Economic Analysis, count fewer sources of user charges in their measure of receipts.)

In the current debate over devolution of authority from the central government to states and localities, it is sometimes assumed that the latter's activities have remained usurped over these past few decades. In point of fact, state and local revenues as a percentage of GDP are far higher in the last few years than they ever have been, even in the pre-Depression, pre-World War II era. States have grown up quite considerably, independently of whether there are federal decisions in the mid-1990s to shift some additional responsibilities to them. In the debate over centralization of power, moreover, it is often ignored that states have centralized power considerably away from local jurisdictions in recent decades.

None of this is to say whether these trends have been good or bad. Political attention, however, is often attracted to the areas where the least, not the most, action is taking place.



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