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THE OUTLOOK

History Casts Doubt On Efficacy of Tax Cuts

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It is tax-cutting time in Washington. With Republicans ascendant in Congress, Bush administration officials are already talking about turning their attention back to tax cuts in the months ahead.

Besides being philosophically disposed to lowering the tax burden on businesses and households, Republicans have another argument for reducing taxes. The limp economy could use more stimulus. Usually, that job falls to the Federal Reserve, which controls short-term interest rates and can try to jolt the economy to life by lowering borrowing costs for businesses and households. But with the benchmark federal funds rate already at 1.25%, its lowest level since 1958, there's little left that the Fed can do.

Now here's a dose of sobering news for anyone expecting tax cuts to provide an alternative solution to the economy's short-term woes. (As if anyone really needed more sobering news.) Two University of Michigan economists, Matthew Shapiro and Joel Slemrod, studied household behavior during and after last year's tax rebates, and found that households didn't spend much of the tax windfall. Instead, they put it toward savings or paying off debt. The implication of this, says Mr. Shapiro, is that last year's tax rebate didn't do much on its own to stimulate the economy in the short-run.

Mr. Shapiro says he wouldn't expect a new push to put cash in consumers' pockets to do much either. That's because debt levels are high -- households now direct about 14% of their after-tax income to servicing their debts, near the highs reached in 1986. Furthermore, savings rates are still low -- Americans on average save 4% of their after-tax income, compared to 8% in the early 1990s and 10% in the early 1980s.

"Consumers are in an asset-rebuilding mode," says Mr. Shapiro. "That will make a tax cut in this environment not very stimulative." Mr. Shapiro served in the White House Council of Economic Advisers during the Clinton administration. Mr. Slemrod served in the Council of Economic Advisers during the Reagan administration.

In March and April, the two Michigan researchers tacked on questions to the university's monthly consumer confidence survey. They asked 1002 people how they used their 2001 rebate checks, which were $300 for individuals and $600 for married couples. Only 25% said they mostly spent the money, while 75% said they either socked it away in savings or used it to pay down debt.

On the face of it, this conclusion is surprising because there actually was a pickup in spending in the final three months of last year. Consumer spending rose at a 6% annual rate in the fourth quarter of 2001, the fastest growth rate since the second quarter of 1998. Mr. Shapiro argues there were a lot of other things going on last year that explain that bounce in spending. Energy prices were falling, mortgage refinancing was booming and auto makers were offering the first wave of 0% financing deals on new cars. Moreover, consumers were bouncing back from the emotional shock of the Sept. 11 terror attacks.

The survey results are doubly surprising because consumers appear to have responded more aggressively to tax cuts in the past. In 1992, for instance, President George H.W. Bush temporarily reduced the amount of money that was withheld from workers' paychecks. Messrs. Slemrod and Shapiro found that individuals spent 40% of that temporary cash windfall. Nicholas Souleles, an economist at the University of Pennsylvania's Wharton School, found that they spent up to 90% of the Reagan tax cuts in 1982 and 1983.

Why the reluctance to use the windfall today? There is some turgid economic theory behind this debate about how consumers behave when taxes are cut. Economists believe that the average American behaves a little bit like a bond trader. Just like a bond trader tries to anticipate future changes in inflation, households try to anticipate future changes in taxes and the economy. A bond trader might sell bonds if he thinks inflation is heading higher. Similarly, an average consumer might be less likely to spend his tax cuts if he believes tax rates are going back up or if he believes his own job prospects are grim.

As a result, consumers might be reluctant to spend tax cuts if they are uncertain about the economic outlook. Moreover, households might not really believe that last year's tax cuts are lasting, so they might be reluctant to act on the cuts.

Martin Feldstein, president of the National Bureau of Economic Research and an adviser to President Bush during the 2000 presidential campaign, says the key to getting consumers to spend is to reassure them by making the tax cuts permanent. For added measure, he says Congress should push the reductions forward. Currently, the next round of lower rates is not set to take effect until 2004.

"It is one of the best things that could be done," he says.

A whole menu of business tax cuts is also on the table. But Mr. Shapiro says tax policy will be no magical elixir this time around. With household finances stretched after the stock market collapse and debt levels still high, he suspects there are a lot of people who might just want to tuck tax breaks away for rainy days.

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