A Temporary Tax Rebate in a Recession: Is it Effective and Safe?

DOES CONSUMER RESPONSE BOOST THE ECONOMY WITHOUT CAUSING DEBT OR INFLATION PROBLEMS?

By Laurence S. Seidman and Kenneth A. Lewis

Is a temporary tax rebate effective and safe as an anti-recession policy? Simulations with an empirically tested macroeconomic model are used to estimate the impact of the actual one-time 2001 tax rebate in the United States and of a hypothetical rebate twice as large, injected four times (quarterly). The results of the simulations are interpreted in light of two important recent empirical studies of the spending of the 2001 rebate by households. We estimate that a rebate equal to three percent of quarterly GDP (roughly the size of the 2001 rebate) repeated four times (quarterly) would reduce the unemployment rate at the end of a year by one percentage point (for example, from six percent to five percent). As along as a tax rebate is detriggered when the recession ends, its use during a recession does not pose a significant debt or inflation problem.

In June 2001, President Bush signed into law a tax cut containing a temporary tax rebate of $600 per married couple ($300 per single person). For the quarter 2001.3, the aggregate rebate was $35.2 billion, about 1.4 percent of that quarter’s GDP of $2,533.8 billion (seasonally adjusted), an annual rate of $10,135.1 billion. The U.S. Treasury mailed these checks out in July, August, and September.1 The purpose of the temporary rebate was to try to promptly stimulate consumer spending to counter the recession. The rebate was the one element of the tax cut that received bipartisan sup-

1The U.S. Treasury reports (Friday issues of The Daily Treasury Statement—Cash and Debt Operations of the U.S. Treasury from July 20th through December 29th) that rebate payments were $6.731 billion in July, $17.448 billion in August, and $10.937 billion in September, for a total of $35.166 billion (an additional $0.702 billion was paid out in the remainder of the year).
port. Should we use a tax rebate again in the next recession? Is a temporary tax rebate effective? Even if it is effective, is it safe? What safeguards can be instituted to reduce the chance that a temporary fiscal stimulus will, inappropriately, become permanent, with adverse long-term consequences for government debt and inflation?

Is a Temporary Tax Rebate Effective?

A half century ago, both Milton Friedman and Franco Modigliani contended that consumers would respond less to temporary tax cuts (or temporary tax rebates) than to permanent tax cuts because rational consumers would adjust consumption fully only in response to a permanent, not temporary, increase in disposable income and would save most of any temporary increase in order to spread consumption smoothly over the rest of their lifetime. But the key practical issue is "how much less." Even if the permanent income and life cycle hypotheses are correct, it is still possible that a temporary tax cut or rebate will provide useful stimulus to an economy in recession. The important empirical question, then, is whether a temporary tax rebate or tax rate cut is sufficiently effective.

An influential study conducted in 2001, published in the American Economic Review in 2003, seemed to imply that the answer is no. In the summer of 2001, through a new module in the University of Michigan Survey Research Center's monthly Survey of Consumers, University of Michigan economists Matthew Shapiro and Joel Slemrod (2003a) asked a sample of consumers what they planned to do when they received the $600 rebate recently enacted by Congress. They asked consumers to look forward (p. 383):

"Thinking about your (family’s) financial situation this year, will the tax rebate lead you mostly to increase spending, mostly to increase saving, or mostly to pay off debt."

The Fall 2001 issue of the newsletter of the Office of Tax Policy Research (2001) at the University of Michigan Business School summarized the results of their survey (pp. 1-2):

"In a survey of 1,500 U.S. households conducted in August, September and October 2001, OTPR Director Joel Slemrod and University of Michigan economics professor Matthew Shapiro found that a surprisingly small percentage of households receiving the federal income tax rebate granted by this year’s tax legislation spent or expected to mostly spend the rebate.... Shapiro and Slemrod found that only 22 percent of households receiving the rebate expected to or had spent the rebate.... The results offer a cautionary conclusion for fiscal policy. Contrary to the desires of policymakers, the tax rebate likely will have little effect in stimulating the economy.... Accordingly, another temporary tax cut, even one targeted at low-income households for which conventional wisdom would have predicted a higher spending propensity, likely would provide little fiscal stimulus."

Shapiro and Slemrod also did a follow-up survey in March and April 2002, asking consumers to look backward (2003a, p. 391): “Did the tax rebate lead you mostly to increase spending, mostly to increase saving, or mostly to pay off debt?”

They reported, “in this survey, 24.9 percent of respondents reported spending the rebate.” In their conclusion, they stated (2003a, p. 394):

“Our finding of a very low spending rate raises a cautionary note about the reliability of fiscal policy in general. It is possible that key parameters such as the propensity to consume are contingent on aggregate conditions in ways that are difficult to anticipate.”

What do the Shapiro/Slemrod consumer surveys imply about the marginal propensity to consume (MPC) out of the rebate? They acknowledged that their consumer surveys do not provide direct information about the MPC out of the rebate because they did not ask what percent of the rebate the person intends to spend. Recall that they asked, “Did the tax rebate lead you mostly to increase spending, mostly to increase saving, or mostly to pay off debt?” For example, if everyone intends to spend 40 percent of the rebate and use 60 percent to pay off debt, then 0 percent would answer “mostly to increase spending,” yet the marginal propensity to consume is 40 percent, not 0 percent. In a subsequent paper they wrote (2003b, pp. 103):

“The aggregate marginal propensity to consume (MPC) from the rebate is an important input for studying the aggregate impact of the tax rebate. Our survey does not provide the MPC directly. Instead, it offers self-reported estimates of the fraction of people who would either mostly spend the rebate or mostly save it, either by adding it to assets or repaying debt.”

They then used their survey results to estimate the MPC. They wrote (2003b, pp. 103-04):

“With some assumptions about what range of individual MPCs correspond to mostly spending