

Executive Summary

CONSUMER RESPONSE TO TAX REBATES

Matthew D. Shapiro and Joel Slemrod
University of Michigan

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Many households received income tax rebates in 2001 of \$300 or \$600. These rebates represented advance payments of the tax cut from the new 10 percent tax bracket. Based on a survey of a representative sample of households, only 22 percent of households said that receiving the rebate would lead them to mostly spend more. Instead, they will either save it or use it to pay off debt. A separate survey taken after the September 11 terrorist attacks shows that the spending response to a new tax rebate would be about the same as the response to the earlier one. This very low rate of spending represents a striking break with past behavior, which would have suggested a much higher rate of spending.

The survey provides no evidence that low-income households are more likely to increase spending, as a liquidity-constraints theory of consumer behavior would suggest. Nor is there any evidence that those who budget by targeting spending are more likely to save, as a rule-of-thumb theory of consumer behavior might suggest.

These findings have significant implications for the impact of fiscal policy on the economy.

- The low propensity to consume implies that the 2001 tax rebate will have a very small impact on aggregate demand.
- Further tax rebates this year would be unlikely to provide a substantial stimulus to the economy.
- A temporary payroll tax reduction would also likely add to household saving and therefore not provide a substantial stimulus.
- Low-income households are not more likely to spend the rebate. This finding runs counter to the belief that a tax rebate would be more effective at stimulating aggregate demand were it targeted at low-income households.

The finding of a very low propensity to consume raises a cautionary note about the effectiveness of fiscal policy in general. Consumer behavior appears to have shifted from what most economists would have expected, both based on economic theory and earlier evidence. It is possible that key parameters such as the propensity to consume are contingent on aggregate conditions in ways that are difficult to anticipate or model. One can speculate about why the spending propensity might have shifted downward under the circumstances of mid-year 2001. Perhaps the negative wealth shocks of the previous two years placed consumers in an asset-rebuilding mode. There may be costs to cutting back consumption, such as a force of habit. Such preferences may cause households to allocate the rebate to saving.