

Expert Doubts Stimulative Effect of Rebate Checks

THE PRESIDENT'S ECONOMIC stimulus plan is supposed to "provide a shot in the arm" to the economy, as Bush himself put it on *Jan. 18*¹. He's hoping millions of people will use their tax rebates to buy iPhones, book vacations to Miami and purchase other things they normally wouldn't, and thereby dodge an economic downturn. For now, the measure is stuck in congressional limbo. It passed the House last week, but on Wednesday the Senate blocked a bid by Democrats to add \$44 billion in help for the elderly, disabled veterans, the unemployed and businesses ~~to~~ *the package*².

At the heart of the measure are rebate checks meant to get Americans to shop. There's a fundamental flaw with the plan, though, says Stephen Horan, head of private wealth at the Certified Financial Analyst Institute: The rebates won't really provide a stimulus and would do little to stave off recession. Horan points to historical research done on tax rebates to show they've been largely unsuccessful. The \$100 to \$200 checks disbursed by the Treasury Department in 1975 had minimal impact on spending. Ditto for the one-shot rebate during the economic slowdown in 2001, according to a 2002 University of Michigan *survey*³.

In the measure's current *iteration*⁴, single taxpayers would get a \$600 rebate that would begin phasing out for those earning more than \$75,000 a year. Married couples would get \$1,200 and the phase-out would start at \$150,000. Parents would receive an additional \$300 per child.

Consumers are only likely to spend about 25% of their checks, Horan says, citing research on tax rebates. Indeed, in a *recent survey*⁵ sponsored by UBS Securities, the International Council of Shopping Centers polled 1,000 Americans asking how they'd use the money if the fiscal stimulus package was signed into law. It found that 43% of respondents said they would use the money to pay down debt, 26% would put in into savings, and 24% would spend it.

Horan says that's because rebates aren't altering people's permanent incomes — which makes the package an inefficient attempt at invigorating the economy. "One-off things that are unpredictable don't encourage people to spend money," he says. "They need to be able to count on the long term."

SmartMoney.com: How effective or ineffective do you think the stimulus package will be?

Stephen Horan: There are different elements to this package. If you focus on the tax rebates, we've seen it before, a number of times. Most recently in 2001 and 2003, we studied how tax payers respond to tax rebates. They don't spend much of it. The marginal propensity to spend the rebates is about 25%. That means that if I get a \$100 tax rebate, I'm going to spend \$25 of it. In this case, it's \$600 [for single taxpayers]. For them, they would spend about \$150. The rest is either saved or used to pay down debt. That's what we saw in 2001 and 2003. There's probably good reason to believe that behavior would prevail this time around.

If we take that behavior and apply it to today, there's \$100 billion, the size of the tax rebate for individuals, and another \$50 billion in tax incentives for businesses. So if about a quarter of that is spent, that's about \$37 billion. That contributes about one-fifth of 1% to GDP growth. In terms of being an economic stimulus, it's not really effective. It's a fairly inefficient way to create an economic stimulus. What this is, essentially, is a wealth transfer from the government to taxpayers. Looked at differently, it's taking debt off taxpayers' balance sheets and putting it onto the government's balance sheet. That's essentially a socialization of debt. But that's largely what's happening.

SM: Why won't consumers be more inclined to spend their new money?

SH: Most of the research into this focuses on the notion of what stimulates the economy is permanent tax cuts. These are one-time rebates, so people don't see it as having a permanent effect on their after-tax income. They see it as a one-off. Because it doesn't have lasting effect on their income, consumers are not likely to change their spending patterns much.

What's kind of counterintuitive — and this happened in 2001 — it's the lower-income taxpayers who tend to spend less of it. And most of the stimulus is targeted to those taxpayers, to the people least likely to spend it. It's difficult to give a tax rebate to someone who doesn't pay taxes. So this is not a tax rebate; it's a wealth transfer. It's giving money to people on the basis of something other than their ability to contribute to the economy.

It's an election year and there are more voters in lower-income brackets than there are in higher-income brackets. Economically this doesn't make sense. My personal view is that it also continues a precedent, which is now turning into a pattern, of anytime there's economic malaise, the United States government is just going to send out checks to people. It's kind of anti-capitalist. Some would say anti-American. It's not the precedent we want to set.

SM: But isn't it meant to be short-term oriented?

SH: It is very short-term oriented. And it's inefficient. If 25% of the money you sent out got re-circulated through the economy,

that's not a whole lot of bang for your buck in my opinion.

SM: As an attempt to help people feel less poor and less strapped, won't an extra few hundred dollars boost confidence?

SH: That's sort of a backdoor way of addressing the notion of what impact this will have on consumer confidence. Consumer psychology can have a self-reinforcing effect. If sentiment turns negative, it will have a negative effect on the economy. And you get this positive feedback loop. You want to avoid reaching that tipping point. The way I liken it is tax rebates are kind of like drinking a Bloody Mary after a long night of partying. No one's going to argue drinking hard liquor the next day will make it better. It can help that transition the morning after.... That's essentially what the tax rebates are. In the short term, it will have an impact. But it's modest and it's not enough to keep us out of a recession. And it's targeted toward people least likely to spend it. It's a wealth transfer that's based on something other than productivity.

SM: Do you think a bigger rebate would be more effective?

SH: It would have a greater effect on economic growth. But it would also have a greater deleterious effect on the national debt. It's still an inefficient way to create economic growth. What you need to do is to have low, stable and predictable tax burdens. One-off things that are unpredictable don't encourage people to spend money. They need to be able to count on the long term. There needs to be predictability in the tax code. Tax rebates don't help the picture. We've got tax cuts set to expire in 2010, and estate taxes expiring and set to come back in 2011. No one knows what's going to happen. That kind of ambiguity is a huge drag on economic efficiency. As an example, if you look at the tax cuts in 2003, the market took off after that, employment picked up, productivity increased. So the evidence is pretty clear.

¹<http://www.reuters.com/article/ousiv/idUSN1829724420080118>

²http://online.wsj.com/article/SB120232403234848325.html?mod=hps_us_whats_news

³<http://www.bus.umich.edu/NewsRoom/WP2002-11.pdf>

⁴http://www.treasury.gov/press/releases/reports/fact_sheet_examples.pdf

⁵<http://www.icsc.org/srch/apps/newsdsp.php?storyid=2392®ion=main>

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