Originally published in **The Wall Street Journal**

August 6, 2008

The Tax Rebate Was a Flop. Obama's Stimulus Plan Won't Work Either.

By MARTIN FELDSTEIN

(PDF Version)

Congress enacted the tax rebate program earlier this year because it perceived a growing risk of recession. In addition, it feared monetary policy alone would not be effective because of the dysfunctional credit markets. As American taxpayers know, most of the rebate checks have now been mailed and cashed.

Those of us who supported this fiscal package reasoned that the program would boost consumer confidence as well as available cash. We hoped the combination would cause households to spend a substantial fraction of the rebate dollars, leading to more production and employment. An optimistic and influential study by economists at the Brookings Institution projected that each dollar of revenue loss would increase real GDP by more than a dollar if households spent at least 50 cents of every rebate dollar.

The evidence is now in and that optimism was unwarranted. Recent government statistics show that only between 10% and 20% of the rebate dollars were spent. The rebates added nearly $80 billion to the permanent national debt but less than $20 billion to consumer spending. This experience confirms earlier studies showing that one-time tax rebates are not a cost-effective way to increase economic activity.

These conclusions are significant for evaluating the likely impact of Barack Obama's recent proposal to distribute $1,000 rebate checks to low- and middle-income workers at an estimated cost of approximately $65 billion. His plan, to finance those rebates with an extra tax on oil companies, would reduce investment in refining and exploration, keeping oil prices higher than they would otherwise be.

Here are the facts. Tax rebates of $78 billion arrived in the second quarter of the year. The government's recent GDP figures show that the level of consumer outlays only rose by an extra $12 billion, or 15% of the lost revenue. The rest went into savings, including the paydown of debt.

For a more comprehensive picture, we can see how households divided their overall increase in disposable personal income -- that is, household income including the rebates and net of income taxes and payroll taxes -- between additional consumer outlays and saving. The official GDP figures show that disposable personal income increased between the first and second quarters by some $98 billion (one-fourth of the annualized figure of $393 billion shown in the government report), up from an increase of $22 billion between the final quarter of 2007 and the first quarter of 2008. So disposable personal income rose by an additional $76 billion, a bit less than the rebates because of declining employment and reductions in other sources of income. The corresponding rise in consumer outlays increased to $36 billion from $24 billion. So the additional $12 billion of consumer spending was less than 16% of the extra $76 billion of disposable personal income. By comparison, savings rose by $62 billion, or five times as much.

These quarterly GDP figures are supported by the more detailed monthly data on income and spending in May and June. According to the government statisticians, the tax rebates in May were $48 billion, accounting for almost all of the $50 billion rise in household disposable income between April and May. In contrast, consumer spending in May rose by less than $6 billion. In June, the rebates were $28 billion. Consumer spending rose by only $5 billion, showing no evidence of an additional delayed effect of the May rebates.

The evidence of a very limited effect on spending is also clear in the monthly retail sales -- a measure that is narrower than total consumer outlays because it excludes things like utility bills and rent. Retail sales were $342 billion a month in January through April and rose to only $346 billion in May and June.

Although press stories emphasizing that the rebates induced additional consumer spending were technically correct, they missed the important point that the spending rise was very small in comparison to the size of the tax rebates.

A recent, widely reported academic study by Christian Broda and Jonathan Parker showing that the rebates led to increased spending on nondurable items (like food and drugs) does not contradict the implication of the more comprehensive data -- on national retail sales and total consumer spending -- that the induced rise in consumer outlays was small relative to the size of the rebate.

The small rise in spending in response to these tax rebates is similar to what previous studies of one-time tax cuts found. It also corresponds to what both basic economic theory and common experience imply. Although someone who receives a permanent annual salary increase of $1,000 typically would increase his annual spending by an almost equally large amount, a $1,000 rise in wealth caused by a share price increase or a tax rebate would raise spending only gradually over a number of years.

All of the evidence on one-time tax rebates implies that the Obama plan to send $1,000 rebate checks would do little to raise consumer spending and stop the decline in employment. If the past is an indicator of what would happen, the $65 billion he proposes to spend on this plan would raise consumer spending by only about $10 billion, or less than one-tenth of 1% of GDP.

The distinction between one-time tax rebates and permanent changes in net income is also important for the debate about Mr. Obama's proposal to raise income and payroll taxes. Because those tax increases would be permanent, they would cause a substantial reduction in consumer spending and aggregate demand. Moreover, as taxpayers begin to focus on the possibility of such a future tax hike, they will reduce spending without waiting for such legislation to be enacted. If Mr. Obama is looking for a way to stimulate the economy, he could begin by discarding his proposal to increase future taxes.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.