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Why Tax Rate Reductions Are More Stimulative Than Rebates: Lessons from 2001 and 2003

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With slower economic growth raising fears of a recession, Washington is abuzz with economic stimulus proposals centered on tax rebates. Tax rebates, however, don't stimulate the economy. Lawmakers currently examining economic stimulus proposals should reject rebates in favor of tax rate reductions.

Tax Rebates Don't Stimulate. By definition, an economy grows when it produces more goods and services than it did the year before. In 2007, Americans produced $13 trillion worth of goods and services, up 3 percent over 2006.

Economic growth requires four main factors: (1) an educated, trained, and motivated workforce; (2) sufficient levels of capital equipment and technology; (3) a solid infrastructure; and (4) a legal system and rule of law sufficient to enforce contracts and contain a functioning price system.

High tax rates reduce economic growth, because they make it less profitable to work, save, and invest. This translates into less work, saving, investment, and capital—and ultimately, fewer goods and services. Reducing marginal income tax rates has been shown to motivate people to work more. Lower corporate and investment taxes encourage the savings and investment vital to producing more and better plants, equipment, and technology.

By contrast, tax rebates fail, because they do not encourage productivity or wealth creation. To receive a rebate, nobody has to work, save, invest, or create any new wealth.

Supporters of rebates argue that they "inject" new money into the economy, increasing demand and, therefore, production. But every dollar that government rebates "inject" *into* the economy must first be taxed or borrowed *out of* the economy. No new spending power is created. It is merely redistributed from one group of people to another. (Even money borrowed from foreigners brings a reduction in net exports.)

Supporters of rebates respond that redistributing money from "savers" to "spenders" will lead to additional spending. That assumes that savers store their savings in mattresses, thereby removing it from the economy. In reality, nearly all Americans either invest their savings (which finances business investment) or deposit it in banks (which quickly lend it to others to spend). Therefore, the money is spent whether it is initially consumed or saved. Given that reality, it is more responsible to let the savers keep that money for a new home or their children's education, rather than to have Washington redistribute it to someone else to spend at Best Buy.

Simply put, low tax rates encourage working, saving, and investing, which in turn encourages job

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creation and wage growth. Tax rebates merely redistribute existing wealth.

The Failed 2001 Tax Rebates. While the 2001 tax cuts reduced some marginal tax rates, the centerpiece was tax rebates. These rebates were rationalized as a pre-payment of the reduction of the lowest marginal income tax bracket from 15 percent to 10 percent. Yet because they were not based on encouraging productive behavior, the rebates had little economic impact.

In the spring and summer of 2001, Washington borrowed billions from the capital/investment markets, and then mailed it to families in the form of $600 checks. In the fourth quarter of that year, consumer spending responded with 7 percent annualized growth, and investment spending correspondingly decreased by 23 percent. The economy grew at a sluggish 1.6 percent annualized rate.[1] The simple redistribution from investment to consumption did not create new wealth.

All traces of the rebate policy effectively disappeared by the next quarter. Consumer spending retreated to 1.4 percent annualized growth, and investment spending partially recovered from its steep decline with a 13.6 percent annual growth. The economy remained stagnant through much of 2002.

The Successful 2003 Tax Rate Cuts. By contrast, the 2003 tax cuts lowered income, capital gains, and dividend tax rates. These policies were designed to increase market incentives to work, save, and invest, thus creating jobs and increasing economic growth. An analysis of the six quarters before and after the 2003 tax cuts (a short enough time frame to exclude the 2001 recession) shows that the policies worked:

- GDP grew at an annual rate of just 1.7 percent in the six quarters before the 2003 tax cuts. In the six quarters following the tax cuts, the growth rate was 4.1 percent.
- Non-residential fixed investment declined for 13 consecutive quarters before the 2003 tax cuts. Since then, it has expanded for 13 consecutive quarters.
- The S&P 500 dropped 18 percent in the six quarters before the 2003 tax cuts but increased by 32 percent over the next six quarters. Dividend payouts increased as well.
- The economy lost 267,000 jobs in the six quarters before the 2003 tax cuts. In the next six quarters, it added 307,000 jobs—and 5.3 million jobs over 13 quarters.[2]

Critics contend that the economy was already recovering and that this strong expansion would have occurred even without the tax cuts. While some growth was occurring naturally, critics do not explain why such a sudden and dramatic turnaround began at the exact moment that these pro-growth policies were enacted. They do not explain why business investment, the stock market, and job numbers suddenly turned around in spring 2003. It is no coincidence that the expansion was powered by strong investment growth, exactly as the tax cuts intended.

Conclusion. The 2003 tax rate cuts succeeded, because they increased incentives to work, save, and invest, thereby creating new wealth. The 2001 tax cuts, based more on demand-side tax rebates and redistribution, did not significantly increase economic growth. Lawmakers currently examining economic stimulus proposals should reject rebates in favor of tax rate reductions.

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1. U.S. Commerce Department, Bureau of Economic Analysis, NIPA Tables, Table 1.1.1, at *www.bea.gov/bea/dn/nipaweb/SelectTable.asp* (January 18, 2008).
2. U.S. Commerce Department, Bureau of Economic Analysis, NIPA Tables, Table 1.1.1, revised, at *www.bea.gov/bea/dn/nipaweb/SelectTable.asp* (January 16, 2007); Yahoo Finance, "S&P 500 Index," at *www.finance.yahoo.com/q/hp?s=%5EGSPC* (January 16, 2007); and U.S. Department of Labor, Bureau of Labor Statistics, "Employment, Hours, and Earnings from the Current Employment Statistics survey (National)," at *http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=CES0000000001&output_view=net_1mth* (January 16, 2007).

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