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They Spent the Tax Rebate. Now What Will Consumers Do?

f you send it, they will spend it.

The third quarter was a phenomenal one for the American economy, which probably grew at an annual rate of above 5 percent. Corporate profits soared.

As that growth occurred, economic optimism grew both in this country and overseas. There was talk that the American engine was again pulling the world back into acceptable growth patterns. Even American business leaders began to seem a little more optimistic, with capital spending plans starting to edge up. Only the negative job market outlook put a shadow on the sunny picture.

Overlooked in some of the analysis at the time was the most obvious fact of all: checks totaling $13.7 billion were being mailed out by Uncle Sam to millions of families. The checks, for the child tax credit, did not go to the poorest Americans, a fact that outraged liberal legislators who learned of the details only after the bill passed. And they did not go to wealthier Americans, who would have been more likely to save the money anyway. They went to the parents in between the two groups.

Now comes the aftermath. The checks were in the hands of Americans in July and August, and clearly lifted spending in the back-to-school season. We don't have September numbers yet, but there was probably some stimulative effect then. But it's over now.

It was fun while it lasted. Personal income was growing slowly on a pretax basis, but after-tax disposable income rose more rapidly in July and August than at any time since early 2002, when tax cuts were also helping the economy along.

For business, that created a bonanza. Revenues leaped, but payrolls, the biggest part of most companies' expenses, stayed the same. A result was a surge in profits.

It would be nice to think the profit surge would lead to more investment and more hiring. There has been a gradual increase in capital spending, which was cut after the 1990's bubble burst. And there are reports of retailers stepping up Christmas orders after being favorably impressed by the back-to-school season. But hiring continues to lag and a big increase in Christmas orders could lead to a blue Christmas as retailers deal with excess inventory.
Another big tax cut seems unlikely, with the federal budget deficit ballooning and the costs of the Iraq occupation rising. So we may be left with what we had before: slow growth and an economy gradually recovering from the overinvestment of the bubble era, particularly in telecommunications and technology.

"The fading of the tax-cut impact means consumption growth will slow significantly in coming months," said Greg Jensen of Bridgewater Associates, an institutional money management firm. "There is some chance this decline will be muted if corporations start hiring, but there are no signs they are doing that yet. Without a significant increase in labor compensation, spending growth will decline significantly and we could be in the early stages of a renewed dip in the economy."

Such a dip need not be severe. The economic recovery lives on, but it will be a gradual one, not the rapid one that some saw in the summer numbers. Monetary policy is likely to remain easy for a long time to come, and as Robert J. Barbera, the chief economist of ITG/Hoenig, notes, the very strong productivity numbers, even after the bubble burst, are a good long-term sign. But the big engine of summer spending is gone, and the economic news may get worse before it gets better.