Why Tax Cuts Fail 2

In my last column, I described why tax cuts don't increase work behavior. Yes, they increase our incentive to work, but they also make it more affordable to work less. A wealth of statistical evidence shows that for most of us, those two effects offset, and we work pretty much the same, with or without the tax cut.

But don't tax cuts increase saving? Once again, no, for three reasons. The first is the same economics logic as with work behavior. Yes, if you reduce my taxes, that raises my after tax rate of return on savings. And that increases my incentive to save. But the reason I save is to be able to spend more in the future – on a future four years in college, or a future down payment on a home, or a future trip to the Caribbean, or my future retirement. And a tax cut that raises my after tax rate of return makes all of those more affordable with less saving.

Suppose you're 20 years old, and want to save enough to retire at age 65, with $2 million in your retirement account. Suppose that before taxes, you can earn an 8% return on your investments, but taxes reduce that to a 6% return.

With a little math, you can calculate that with the 6% after tax return, you'd need to save $722 a month for the next 45 years to have $2 million in savings by age 65. But with a tax cut that raises your rate of return to 8%, you'd only need to save $377 a month to reach that exact same goal. With the tax cut, you can afford to save slightly more than half as much, and still reach your retirement goal.

So economic analysis tells us that tax cuts could result not in more saving, but possibly in less saving – just like they affect working.

Behavioral economists disagree with this story. Almost no one thinks about saving that analytically, they argue, which is the second reason to conclude that tax cuts have no impact on saving. What amount did you save last year, including things like your increased equity in your home? Do you even know? And what was your rate of return on your savings? Do you have even the foggiest idea?

The reality is, almost nobody precisely analyzes their saving decisions, because we humans are absolutely lousy at doing that. Many of us, just to be sure we save at all, force ourselves to do so automatically, by having part of every paycheck automatically put into a retirement account. But responding to some after tax rate of return? Do you know anyone who chose not to buy a new pair of shoes, because that $60 could be earning 7% interest? Neither do I.

There's a third reason to conclude that tax cuts don't impact saving: the data. Unlike with work behavior, where we have lots of detailed information on how many hour people work each week, we don't have good detailed information of how many dollars people save each week – mostly because those lots of people don't know exactly how much they saved, either. What we do have are measures of total U.S. savings. And those show no relationship whatsoever between after tax rates of return and the total amount that gets saved.

So if you're a person who believes either in economic analysis, or in the insights of behavioral economics, or in drawing conclusions from observed facts, you can only conclude that the Supply Side claim that tax cuts will boost saving is utterly false. Utterly, totally false.