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Consumer response to the 1998 tax cut: Is a temporary tax cut effective? ☆

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The Japanese Government implemented two tax cut packages in 1998 to alleviate the weakness of the economy. Those were temporary and the eligible amount for each household was based on the number of family members. Using monthly data from the Family Income and Expenditure Survey, we explore the variation in the impact of the tax cut episode across families with different numbers of family members to identify its impact on consumption. Our estimates indicate that consumers responded to the 1998 tax cut with the implied MPC of 0.6 on impact with stimulating services consumption but the MPC declined in subsequent months. *J. Japanese Int. Economies* **20** (2) (2006) 269–287. Institute of Economic Research, Hitotsubashi University, Tokyo, Japan.

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1. Introduction

The Japanese economy peaked out in the spring of 1997 right after the consumption tax rate was raised from 3 to 5% in April and fiscal consolidation had been completed. The onset of the Asian financial crises and the financial crisis in Japan itself in the fall of 1997 exacerbated the economic downturn. In order to alleviate the weakness of the economy, the Japanese Government implemented temporary tax cuts, called "special tax cuts," in two 1998 tax packages incorporating national income tax cuts and local inhabitant's tax cuts. The sum of those tax cuts was four trillion yen (about 40 billion dollars), which was roughly equal to that of the consumption tax increase in the previous year.

The paper takes advantage of rich household-level data to evaluate how the 1998 temporary tax cut packages stimulated consumption. Although tax reduction policies were undertaken every year after the mid-1990s, any positive macro-level effects were not clearly observed in the 1990s, which poses a major challenge for policy makers and academics. Surprisingly, despite of its policy importance, there has been little research on households' reaction to those tax policy changes based on micro-level data.

Among those episodes, the timing of the 1998 tax cuts was unique in that those were implemented right after falling into an unusually severe contraction due to the unprecedented events. Moreover, what was unique in the 1998 tax cuts was that a household's tax cut amount was based upon the number of dependants, regardless of household income level. Therefore, we are able to explore the variation in the impact of the tax cut episode across families with different numbers of family members to identify its impact on consumption. In Japan, the amount of national income tax due from monthly salary is determined through the "withholding table," based upon the number of dependants and current monthly income of a household. The amount of local inhabitant's tax is fixed per month between June and May determined by the previous year's annual income. Both tax payments are withheld from salary and the amounts are exogenously determined.

Thus, the Japanese tax cut episode in 1998 is a nice "natural experiment," offering an opportunity to evaluate the effectiveness of tax cut policy. In addition to its relevance for Japanese fiscal policy, this paper also contributes to the large literature on the empirical relevance of the life-cycle/permanent income hypothesis (LC/PIH) of consumption. Recent work in this area exploits quasi-natural experiments to identify households that are subject to anticipated income changes.[2] To our knowledge, our study is one of the first attempts to take tax cut episodes as a natural experiment to test the LC/PIH in Japan using individual micro data.

On tax policies, there are at least two recent papers that investigate Japanese experiences using other source of data. Watanabe et al. (2001) tackled an empirical assessment of Japanese tax cuts after the mid 1970s, distinguishing temporary and permanent as well as anticipated and unanticipated tax changes. Following the methodology of Poterba (1988),[3]

[2] See Browning and Collado (2001), Hori et al. (2002), Hsieh (2003), Parker (1999), Shea (1995), Souleles (1999, 2002) and Shimizutani (2002).

[3] Consumers are divided into four types; current income consumers, permanent income consumers, near-rational consumers and Ricardian consumers. Watanabe et al. (2001) suggest that the Japanese consumers follow a near-rational decision rule.