US Consumers Keep Spending Despite Higher Taxes

By Chris Rugaber - April 29, 2013

WASHINGTON (AP) — This year got off to a sour start for U.S. workers: Their pay, already gasping to keep pace with inflation, was suddenly shrunk by a Social Security tax increase.

Which raised a worrisome question: Would consumers stop spending and further slow the economy? Nope. Not yet, anyway.

On Friday, the government said consumers spent 3.2 percent more on an annual basis in the January-March quarter than in the previous quarter — the biggest jump in two years. And in a report Monday, the government said consumers increased their spending in each month, by 0.2 percent in March, 0.7 percent in February and 0.3 percent in January.

The spending increases highlighted a broader improvement in Americans' financial health that is blunting the impact of the tax increase and raising hopes for more sustainable growth.

Consumers have shed debt. Gasoline has gotten cheaper. Rising home values and record stock prices have restored household wealth to its pre-recession high. And employers are steadily adding jobs, which means more people have money to spend.

"No one should write off the consumer simply because of the 2 percentage-point increase in payroll taxes," says **Bernard Baumohl, chief economist at the Economic Outlook Group**. "Overall household finances are in the best shape in more than five years."

Spending weakened toward the end of the January-March quarter. Spending at retailers fell in March by 0.4 percent, the worst showing in nine months. And more spending on utilities accounted for up to one-fourth of the increase in consumer spending in the January-March quarter, according to JPMorgan Chase economist Michael Feroli, because of colder weather.

Higher spending on utilities isn't a barometer of consumer confidence the way spending on household goods, such as new appliances or furniture, would be.

Americans also saved less in the first quarter, lowering the savings rate to 2.6 percent from 3.9 percent in 2012. Economists say that was likely a temporary response to the higher Social Security tax, and most expect the savings rate to rise back toward last year's level. That could limit spending.

But several longer-term trends are likely to push in the other direction, economists say, and help sustain consumer spending. Among those trends:

— WEALTH IS UP

Home prices rose more than 10 percent in the 12 months that ended in February. And both the Dow Jones industrial average and Standard & Poor's 500 stock indexes reached record highs in the first quarter. As a result, Americans have recovered the $16 trillion in wealth that was wiped out by the Great Recession. Economists estimate that each dollar of additional wealth adds roughly 3 cents to spending. That means last year's $5.5 trillion run-up in wealth could spur about $165 billion in additional consumer spending this year. That's much more than the $120 billion cost of the higher Social Security taxes.

"The resilience in spending, despite increased taxes, suggests that rising household wealth is providing an offset" to higher taxes and spending cuts, says James Marple, an economist at TD Bank.

— DEBT IS DOWN

Household debt now equals 102 percent of after-tax income, down from a peak of 126 percent in 2007. That's almost back to its long-term trend, according to economists at Deutsche Bank. And households are paying less interest on their debts, largely because of the Federal Reserve's efforts to keep borrowing rates at record lows. The percentage of after-tax income that Americans spent on interest and debt payments dropped to 10.4 percent in the October-December quarter last year. That's the lowest such figure in the 32 years that the Federal Reserve has tracked the data.

— JOBS ARE UP

Employers have added an average of 188,000 jobs a month in the past six months, up from 130,000 in the previous six. Job gains slowed in March to only 88,000. But most economists expect at least a modest rebound in coming months. And layoffs sank to a record low in January. Fewer layoffs tend to make people feel more secure in their jobs and more willing to spend.

— GAS PRICES ARE DOWN

Gasoline prices have fallen in the past year and are likely to stay low. Nationwide, the average price of a gallon of gas has dropped 28 cents since this year's peak of $3.79 on Feb. 27. Analysts expect gas to drop an additional 20 cents over the next two months. Each 10 cent drop over a full year translates into roughly $13 billion in savings for consumers.

— LOAN COSTS ARE DOWN

Lower interest rates have enabled millions of Americans to save money by refinancing their mortgages. Mortgage giant Freddie Mac estimates that in the fourth quarter of 2012, homeowners who refinanced cut their interest rate by one-third, the biggest reduction in 27 years the agency has tracked the data. On a $200,000 loan, that means $3,600 in savings over the next 12 months.

Some economists note that the Social Security tax cut didn't spur much more spending when it first took effect at the start of 2011. The tax cut gave someone earning $50,000 about $1,000 more to spend each year. A household with two high-paid workers had up to $4,500 more.

Despite the tax cut, Baumohl notes that consumer spending rose only 2.5 percent in 2011 and 1.9 percent in 2012. In the 10 years before the recession began in December 2007, the average annual spending increase was 3.4 percent.

And a study by the Federal Reserve Bank of New York found that consumers spent only 36 percent of the increased income that resulted from the tax cut. The rest went to paying down debt or to savings.

Since the tax cut didn't boost spending that much, its expiration may not drag it down much, either. Economists say temporary tax cuts are often ineffective because many consumers assume that the tax breaks will eventually disappear. So they don't ramp up spending in response.

Scott Loehrke, 25, hasn't cut back spending this year. Loehrke went ahead in March with some car repairs that could have been delayed. And he still plans to vacation in May in Mexico with his wife, Jackie.

The couple, who live just outside Cleveland, feel secure in their jobs. Loehrke is a salesman for a company that makes T-shirts, cups, key chains and other promotional products. Business has picked up in the past year as the economy has improved. His wife is a pharmacist.

"Everything that we've planned to do we're still doing," Loehrke says.

The Loehrkes both have heavy student debt and so are focused on keeping their expenses in check. They both drive used cars. That's enabled them to build up some savings and made it easier to absorb the tax increase.

New threats have emerged. Across-the-board government spending cuts kicked in March 1. The spending cuts have triggered government furloughs and could lead private companies that do business with the government to cut staff. And the cuts are expected to shave a half-point from economic growth this year.

Even so, most economists are relieved that consumers have proved so resilient so far.

"It's very encouraging that consumers and thus the broader economy have been able to weather that storm as well as they have," says Mark Zandi, an economist at Moody's Analytics.