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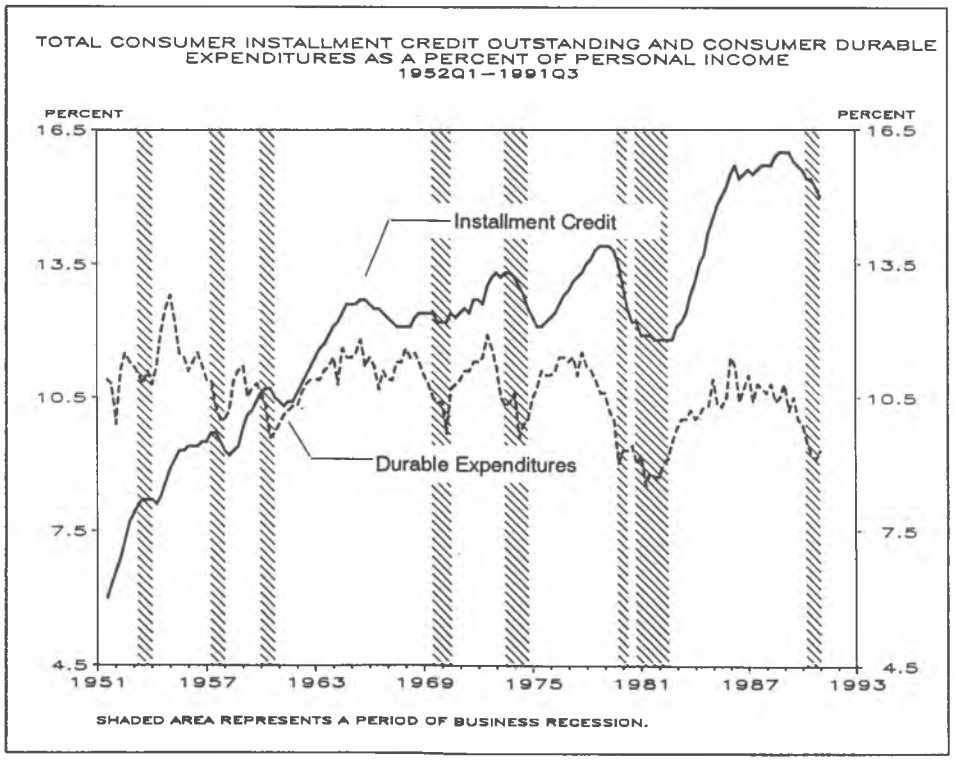
The Tax Act of 1986 and Its Effects on Consumer Borrowing

The Tax Reform Act of 1986 initiated the phasing-out of deductions for interest on consumer debt (except for mortgages) and also reduced households' marginal tax rates, thereby diminishing the value of the remaining deduction. In each year, beginning in 1987, households were permitted to deduct a declining portion of their interest expense from their taxable income. Since 1990, the deduction has been completely eliminated. Has the loss of the interest deduction had an effect on consumer borrowing in general and on the sales of consumer durables in particular? The accompanying chart suggests a few answers.

Consumer installment credit outstanding measures the short- to medium-term credit used to finance personal consumption or refinance consumer loans; it excludes home equity loans. The Commerce Department classifies the ratio of consumer installment credit to personal income as a lagging indicator, which means that the ratio historically has fallen late in a recession. In the most recent episode, this ratio peaked almost a year and a half before the recession began in July 1990, suggesting that the Tax Reform Act slowed down consumer borrowing in the second half of the 1980s.

The chart also shows spending on consumer durables as a percentage of personal income. The recent downturn in this ratio occurred at about the time of the implementation of the 1986 Tax Act. Viewed in historical perspective, however, this ratio always peaks long before a recession begins. Consequently, it is difficult to conclude whether this most recent downturn in consumer durables spending is a response to the tax change or to normal cyclical forces.

— Michael J. Ducker



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