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First Trust

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# Monday Morning Outlook

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## Disagreeing With Laffer About 2011

Policy matters: Especially, tax rates. Over time, few things affect economic activity more than absolute and relative tax rates. In addition, changes in tax rates, particularly when they can be anticipated ahead of time, can also result in shifts in the timing of economic activity.

Recently, Arthur Laffer – prominent economist and inventor of the Laffer Curve – fretted about the economic impact of the expiring (2003) Bush tax cuts. In a Wall Street Journal opinion piece he wrote that the tax hikes would lift growth in 2010, but cause a double-dip recession in 2011 when the rates actually went up.

Dr. Laffer cites the early 1980s – when Ronald Reagan phased-in his tax cuts between 1981 and 1983. This caused the recovery to be put off until 1983, when tax rates were finally cut fully. But it's 1993, not 1983, that offers a more accurate historical example. President Clinton lifted the top marginal income tax rate from 31% in 1992 to 39.6% in 1993 (or 42.5% if the 1993 Medicare tax hikes are included).

The economy grew at a 4.3% annual rate in the last quarter of 1992, the same pace as 1992 as a whole. Then, in the first half of 1993, the economy grew at only a 1.7% annual rate. So it seems clear that some activity that otherwise would have happened in early 1993 got shifted into late 1992 to avoid higher tax rates.

But once this was past, the economy accelerated. Real GDP grew 3.7% at an annual rate in the second half of 1993 and then 4.2% for the full year of 1994. No recession.

The problem with economics is that there are always multiple things happening at once. Back in 1993, the Federal Reserve was holding the federal funds rate at 3% - a clear policy of easy money. This helped offset the impact of the tax hikes and kept the economy growing.

This time around, not only is the Fed holding the federal funds rate near zero, but income tax hikes scheduled for 2011 are less severe than those of 1993.

Raising the top tax rate from 35% to 39.6% is not good policy, but it's smaller than the tax hike the US weathered two decades ago. Moreover, there is a huge election in November that could change the course of policy in dramatic fashion.

We are certain this is difficult for supply-siders and conservatives to swallow. Arthur Laffer is a mentor, and a leader of free market thinking. And while we disagree with him about 2011, we agree that over time higher tax rates in the US will help shift business toward countries with lower tax rates.

Unless, that is, we see another major shift in policy like we did in the mid-1990s. Back then, once the Fed lifted interest rates and withdrew monetary stimulus, Bill Clinton signed laws pushing free trade, welfare reform, and capital gains tax cuts. All of a sudden, the economy had a nice tailwind. The late 1990s experienced an economic boom despite higher marginal tax rates on regular income.

With elections looming, we can't rule out a shift in policy one way or another. What we can say is that the last time tax rates went up like they are scheduled to in January the economy did not fall into an immediate recession.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 6-15 / 7:30 am | Empire State Mfg Index - Jun | 20.0 | **25.0** | | 19.1 |
| 7:30 am | Import Prices - May | -1.2% | **-1.0%** | | +0.9% |
| 7:30 am | Export Prices - May | +0.0% | **+0.1%** | | +1.2% |
| 6-16 / 7:30 am | PPI - May | -0.5% | **-0.4%** | | -0.1% |
| 7:30 am | "Core" PPI - May | +0.1% | **+0.1%** | | +0.2% |
| 7:30 am | Housing Starts - May | 0.650 Mil | **0.653 Mil** | | 0.672 Mil |
| 8:15 am | Industrial Production - May | +0.9% | **+1.3%** | | +0.8% |
| 8:15 am | Capacity Utilization - May | 74.5% | **74.7%** | | 73.7% |
| 6-17 / 7:30 am | CPI - May | -0.2% | **-0.1%** | | -0.1% |
| 7:30 am | "Core" CPI - May | +0.1% | **+0.1%** | | +0.0% |
| 7:30 am | Current Account Balance (Q1) | -$122.2 Bil | **-$125.6 Bil** | | -$115.6 Bil |
| 7:30 am | Initial Claims - Jun 12 | 451K | **453K** | | 456K |
| 9:00 am | Philly Fed Survey - Jun | 20.0 | **21.0** | | 21.4 |
| 9:00 am | Leading Indicators - May | +0.4% | **+0.5%** | | -0.1% |