Tax Hikes and the 2011 Economic Collapse

By ARTHUR LAFFER

People can change the volume, the location and the composition of their income, and they can do so in response to changes in government policies.

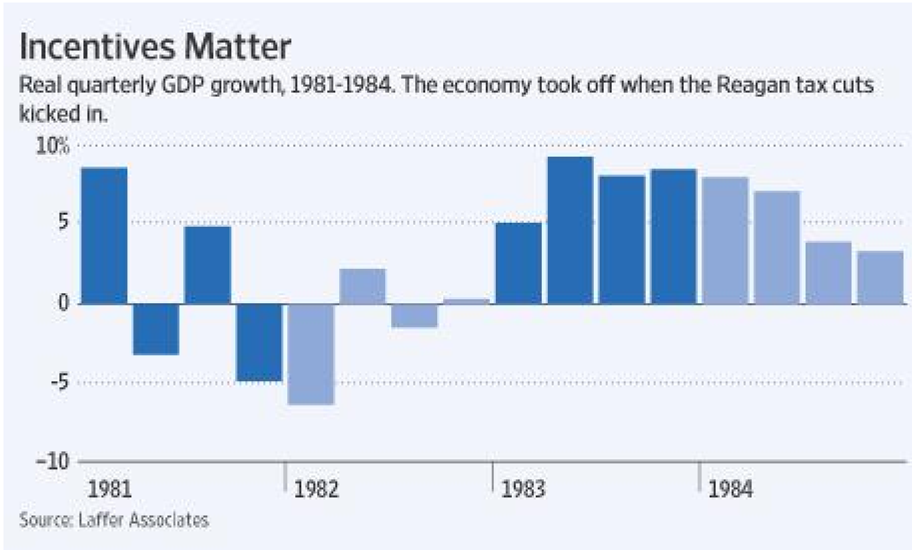
It shouldn't surprise anyone that the nine states without an income tax are growing far faster and attracting more people than are the nine states with the highest income tax rates. People and businesses change the location of income based on incentives.

People can also change the timing of when they earn and receive their income in response to government policies. According to a 2004 U.S. Treasury report, "high income taxpayers accelerated the receipt of wages and year-end bonuses from 1993 to 1992—over $15 billion—in order to avoid the effects of the anticipated increase in the top rate from 31% to 39.6%. At the end of 1993, taxpayers shifted wages and bonuses yet again to avoid the increase in Medicare taxes that went into effect beginning 1994."

Just remember what happened to auto sales when the cash for clunkers program ended. Or how about new housing sales when the $8,000 tax credit ended? It isn't rocket surgery, as the Ivy League professor said.

On or about Jan. 1, 2011, federal, state and local tax rates are scheduled to rise quite sharply. President George W. Bush's tax cuts expire on that date, meaning that the highest federal personal income tax rate will go 39.6% from 35%, the highest federal dividend tax rate pops up to 39.6% from 15%, the capital gains tax rate to 20% from 15%, and the estate tax rate to 55% from zero. Lots and lots of other changes will also occur as a result of the sunset provision in the Bush tax cuts.

Tax rates have been and will be raised on income earned from off-shore investments. Payroll taxes are already scheduled to rise in 2013 and the Alternative Minimum Tax (AMT) will be digging deeper and deeper into middle-income taxpayers. And there's always the celebrated tax increase on Cadillac health care plans. State and local tax rates are also going up in 2011 as they did in 2010. Tax rate increases next year are everywhere.



Now, if people know tax rates will be higher next year than they are this year, what will those people do this year? They will shift production and income out of next year into this year to the extent possible. As a result, income this year has already been inflated above where it otherwise should be and next year, 2011, income will be lower than it otherwise should be.

Also, the prospect of rising prices, higher interest rates and more regulations next year will further entice demand and supply to be shifted from 2011 into 2010. In my view, this shift of income and demand is a major reason that the economy in 2010 has appeared as strong as it has. When we pass the tax boundary of Jan. 1, 2011, my best guess is that the train goes off the tracks and we get our worst nightmare of a severe "double dip" recession.

In 1981, Ronald Reagan—with bipartisan support—began the first phase in a series of tax cuts passed under the Economic Recovery Tax Act (ERTA), whereby the bulk of the tax cuts didn't take effect until Jan. 1, 1983. Reagan's delayed tax cuts were the mirror image of President Barack Obama's delayed tax rate increases. For 1981 and 1982 people deferred so much economic activity that real GDP was basically flat (i.e., no growth), and the unemployment rate rose to well over 10%.

But at the tax boundary of Jan. 1, 1983 the economy took off like a rocket, with average real growth reaching 7.5% in 1983 and 5.5% in 1984. It has always amazed me how tax cuts don't work until they take effect. Mr. Obama's experience with deferred tax rate increases will be the reverse. The economy will collapse in 2011.

Consider corporate profits as a share of GDP. Today, corporate profits as a share of GDP are way too high given the state of the U.S. economy. These high profits reflect the shift in income into 2010 from 2011. These profits will tumble in 2011, preceded most likely by the stock market.

In 2010, without any prepayment penalties, people can cash in their Individual Retirement Accounts (IRAs), Keough deferred income accounts and 401(k) deferred income accounts. After paying their taxes, these deferred income accounts can be rolled into Roth IRAs that provide after-tax income to their owners into the future. Given what's going to happen to tax rates, this conversion seems like a no-brainer.

The result will be a crash in tax receipts once the surge is past. If you thought deficits and unemployment have been bad lately, you ain't seen nothing yet.

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