Finding Revenue

By John Mauldin | December 16, 2023

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If you really want to reduce the federal debt, you don't have to convince Congress of anything. You can just write a check. The Treasury Department gladly accepts gifts from anyone so inclined.

Few are, apparently. So far this year, donations totaled less than $1 million. Shocking, no? <grin>

The government's revenue is mostly involuntary via taxes, and it's still not enough to cover spending. We fill the gap with borrowed money that must eventually be repaid from tax revenue with interest.

We can and should work to reduce spending, but finding more revenue is part of the answer, too. The easy button went away 20 years ago during Bush 2. It could have been fixed under Obama except once again everyone wanted to spend more and Congress wouldn't raise taxes enough to cover it. Interest rates were low so why not borrow when rates were 2% or less? Ironically, interest costs went down even as the debt increased. Now we are paying the piper.

Now, when I say the government needs more revenue, it doesn't necessarily mean via income tax. That's just one kind of tax. There are things we can do to make that system fairer and more efficient, but also other ways to raise revenue. When the crisis hits, and it will, everything should be on the table as we seek ways out of this mess.

I know there are readers who would prefer not to raise taxes and would somehow like to think that we can do it with cutting spending. I was in that camp myself for decades. The markets aren't going to give us our wish.

At some point in the future when the debt is clearly unacceptable to the markets, bond buyers will want to see at a minimum a plan that keeps the deficit under nominal GDP. We will need something closer to balanced budgets and a clear path to sustainability.

When I write we're going to need more tax revenue, it is not because I think US citizens are undertaxed. It is that we have increased our spending in ways nobody wants to cut. Think pensions, Social Security, Medicare, and a host of government benefits. It is technically possible to cut them, but not politically possible. When the crisis comes, we will have to compromise. Those who want government spending are going to have to accept lower spending through a variety of means testing, simple across-the-board cuts here and there, etc.

Those who have always opposed tax increases of any kind (I'm looking at you, Grover) because any tax increase lets government get bigger will have to accept that taxes must be raised. Their goal should be to determine what is the best way to increase revenue while doing the least damage to individuals and the economy.

Nobody is going to be happy. That's just the world we live in. We have dug a very deep hole and unfortunately, we continue to dig. At some point we're going to have to stop digging and start filling.

It would be nice to have some magic bullet fix everything. I don't believe it will work that way. The answer, if it exists, will more likely be a combination of many smaller solutions. None will suffice on their own, but each can contribute.

As a political matter, "spreading the pain" may also be the only way to reach consensus. People will be more willing to sacrifice if they see others giving up something, too. I think I conclusively demonstrated last week that simply raising income taxes is nowhere near sufficient and is potentially destructive if taken too far. That does not mean we don't need more revenue.

Today I want to follow up last week's Fair Shares of Debt letter by exploring some other ways to raise revenue. As you'll see, none of these are "the" answer but they may be *part* of the answer.

Raising Cash

Let me begin with what should be an obvious, if philosophical, point. A tax system's purpose is to *raise cash for government expenses*. In my opinion, part of the solution is to recognize taxation shouldn't be a tool of social engineering, used to reward some behaviors and punish others. That's inevitably what will happen, of course; people will respond to whatever incentives the tax system offers. But the system should try to minimize those incentives out of fairness *and* to reduce economic distortions. We'll soon find our revenue needs no longer allow the luxury of rewarding some groups over others with tax benefits.

Government debt is one of those distortions. With the power to tax, governments shouldn't *need* to borrow except in rare emergencies like war. The mere presence of that debt distorts the private bond markets. It forces households and businesses to compete against the government for the available supply of credit. Some government debt is necessary for the functioning of the financial markets, benchmarks, etc. But not $35 trillion going to $60 trillion.

Taxes distort the economy as well but have the advantage of not generating additional interest costs. So generally (again, with exceptions like infrastructure, etc.) it's better to fund government via taxes than debt.

I'm not saying everything government does is worthwhile. Much of it isn't but that's a discussion for another time. My point here is that whatever government functions we think are legitimate should, ideally, be funded through taxes, with debt added only in crisis situations.

As we have seen in this series and particularly last week, however, US tax revenue is nowhere near enough to cover the spending we seem to demand. Hence the annual deficits which compound into an ever-growing national debt. To change this, we need to somehow bring tax revenue in line with expenditures.

Capital and Labor

In an income tax system, tax revenue should rise if income rises. But it's not quite that simple because different types of income are taxed differently.

Wage income, or money you are paid in exchange for your time and labor, is taxed at gradually rising rates. The highest bracket is currently 37%. That same income is also subject to payroll taxes for Social Security and Medicare (anywhere from 1.45% to 3.8%), up to a certain threshold.

The US also taxes capital gains, which is income derived from buying and selling assets (stocks, real estate, etc.) held more than a year. These rates are much lower—currently 20% at most, with an additional 3.8% Medicare tax in some cases.

This discrepancy between capital and labor income was originally intended to encourage capital investment and help the economy grow. It worked, too. But it also has unintended consequences. The fact that you pay capital gains tax only when the gain is realized produces a "lock-in" effect as investors hesitate to sell assets with open gains, knowing it will trigger a tax liability.

You probably see this in your portfolio decisions. You have a stock with a big gain. It might get even bigger, or it might shrink if the stock price falls. The money might perform better in something else, but a "sell" decision has tax consequences. This is messy and confusing, sometimes leading to poor decisions [not unlike Keynes' Paradox of Thrift (Savings)].

The same thing happens at the macro level. Often the economy would benefit if more people sold their underperforming assets and moved the proceeds to other ventures with higher potential upside. The tax system encourages them to stay put.

The fact investors can choose when to be taxed while workers can't also creates some inequity in the system. Many workers *are* investors, of course, and enjoy that same privilege for their investment income. But the benefit of lower capital gains rates still goes mainly to the wealthy, since they are the largest owners of capital.

One proposal would change this by taxing capital gains and dividends at ordinary income rates for taxpayers with income above some threshold. This would almost double the top rate on that income from 20% to 37%. It seems to me that this would potentially worsen the lock-in problem.

Experts who try to estimate the revenue from this usually find surprisingly low numbers, due mainly to that lock-in effect. The CRFB calculator I referenced last week has an option that would raise only $240 billion over 10 years. I say "only" even though it is a huge sum of money because this amount is only about 12% of the roughly $20 trillion needed to balance the budget by 2033. And it would do so only by significantly infringing on the capital markets, which would likely have other negative effects.

Some capital gains tax reforms may be part of the solution but won't be near enough. We have to keep digging.

Death and Wealth

The best example of taxation as social engineering, rather than revenue source, is the estate tax. The ultra-wealthy have many ways to avoid it and rarely pay much. What little is paid comes from less-wealthy small business owners, farmers, and investors who don't have access to those tools or don't think to use them.

The estate tax that has never raised much revenue. It exists mainly to serve the ideological goal of reducing dynastic wealth but doesn't actually do so. It simply generates a lot of income for accountants and tax lawyers—good for them but not economically beneficial. Nevertheless, people keep trying.

Personal anecdote but which is played out thousands of times: I have a good friend who is inheriting a massive estate from his grandfather (born in 1910) who made a massive amount of money and then created a generation-skipping trust that my friend gets and then his grandkids will ultimately benefit from. Don't feel sorry for his kids as they get money from a different generation-skipping trust from his father. Plus, so many other angles it is mind boggling.

The estate tax was much more onerous before 2009, when the threshold at which it applies was raised and indexed to inflation. Then it was raised again in 2017. According to CRFB, rolling back those changes to the pre-2009 level would produce about $370 billion in debt reduction over 10 years. ***That number depends heavily*** on how people with large estates respond; many would just rearrange their affairs and still pay nothing. The revenue raised could be substantially less.

So, similar to capital gains reform, estate tax reform would raise some money but at best be only a small part of a debt solution. Realizing this, some progressives prefer to tax wealth annually while the owner is still alive. CRFB analyzes an "Ultra-Millionaire Wealth Tax" that would impose a 2% yearly tax on all net worth above $50 million and 3% on all net worth above $1 billion. This would produce far more revenue than the estate tax—an estimated $2.71 trillion over 10 years. Or would it? As every investor and accountant knows, "net worth" is a slippery concept. Defining it requires putting an estimated value on illiquid assets like homes, real estate, closely held businesses, artwork and collectibles, yachts, etc. How does that happen? I don't know but I can foresee a lot of disputes and enforcement problems. Breathes there a soul who hasn't seen an asset get huge and then fall? What if you got taxed at the top? Will the government pay you back when you lose?

One thing that might happen is a move to store more wealth in subjectively valued assets. A publicly traded stock is easy for the IRS to value. A private company isn't. So, we might end up with fewer public companies, meaning fewer opportunities for average people to invest their savings alongside the wealthy. That doesn't seem helpful.

But before you even reach that point, there's the question of whether wealth would even stick around to deal with such a tax. An old rule of public policy is that you get more of something when you subsidize it and less by taxing it. Taxing wealth would give the wealthy a reason not to be US residents and citizens. Money flows to where it is treated the best. A wealth tax in the US might give the world's best and brightest reason to go elsewhere – over time making our debt problem worse instead of better.

Stabilizing the budget will require a whole new approach to taxation. The good news: there may be one. More on that in my next letter.

Energy Might Help Offset Your Taxes

Longtime readers will know that I am bullish on oil and gas in the medium and long term, precisely because the ESG movement, including numerous governments, is limiting both the amount of money and places that can be drilled for oil and gas. Economics 101 says that if you reduce a supply of something that has an increasing demand the price is going to rise. Felix Zulauf and others are about $120–$150 oil next year. In a normal world, that shouldn't happen, yet it seems likely to me.

For some, investing in oil and gas may provide significant tax benefits. You should check it out. Of course, you should consult your tax advisors on this.

For those with true risk capital, I would invite you to see what we are doing at King Operating. We are physically drilling for oil and gas in older, underdeveloped fields, planning to improve their value. Typically, the older fields were all vertical wells, but you can improve the value of that old field by using modern technology and doing horizontal drilling and fracking. It is similar to buying an older apartment complex in a great neighborhood, upgrading and renovating it, raising rents and then selling it to someone who wants to be in the apartment management business.

I will be doing a webinar next Tuesday, December 19, at 6 pm ET. We will of course discuss energy, price movements, taxes, where we are in our drilling process, oil and gas production, and so much more, and answer your questions! You can register below. It will be fun and informative, and you want to be there!

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To register for the webinar click here.

New Year's, Cape Town, and the Need for AI

Maybe the world is getting back to normal. My international travel schedule in the past was driven by speaking engagements. People would pay me significant money to travel the world and speak. Pretty awesome gig. That stopped with COVID, not just for me but for many of my friends. I'm finally starting to see a few speaking requests. Shane and I will be going to Cape Town in South Africa in June.

I will tell you that I miss traveling and speaking. I'm looking forward to the day that comes back. Maybe not the 250,000 miles a year I used to do, but more than my sedentary lifestyle today.

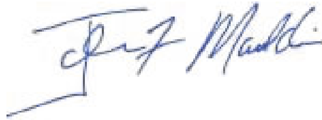
I have been banking at Capital One for over a decade. Initially, it was a good relationship. We started with personal bankers and now there are none, at least for someone of my minor standing. Recently I tried to simply send a wire (larger than usual) and Capital One would not send it, took the money out of my account, and then froze my account. We spent six hours (my associate Tammi and I) working through dozens (not an exaggeration) of different people, who would "transfer" us to someone who eventually dropped the call, and never called back. Repeatedly. They all asked the same questions and they all acted as if they had not seen anything in their records. One person actually told us that Puerto Rico was not part of the US and therefore they would have to close our account. Swear to God.

It got worse. Their concern was that somehow, I had been manipulated into fraudulently sending money. Their phone numbers don't work from Puerto Rico, so I couldn't call in on my cell. Even when I sent them a copy of my driver's license to their platform, they didn't believe that it was me. We eventually had to send the wire from another account from another bank here in Puerto Rico. Capital One desperately needs some intelligence, artificial or otherwise.

Tonight is the annual Christmas party for our local community, a small gathering of 600+ people. It is one of the great highlights of the year, with lots of friends. My New Year's Day party list is now over 100 people and counting.

And with that, it's time to hit the send button and wish you a great week. Next week we will talk about the upside of the coming crisis. And don't forget to follow me on X.

Your getting the irony of talking about taxes while in Puerto Rico analyst,



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