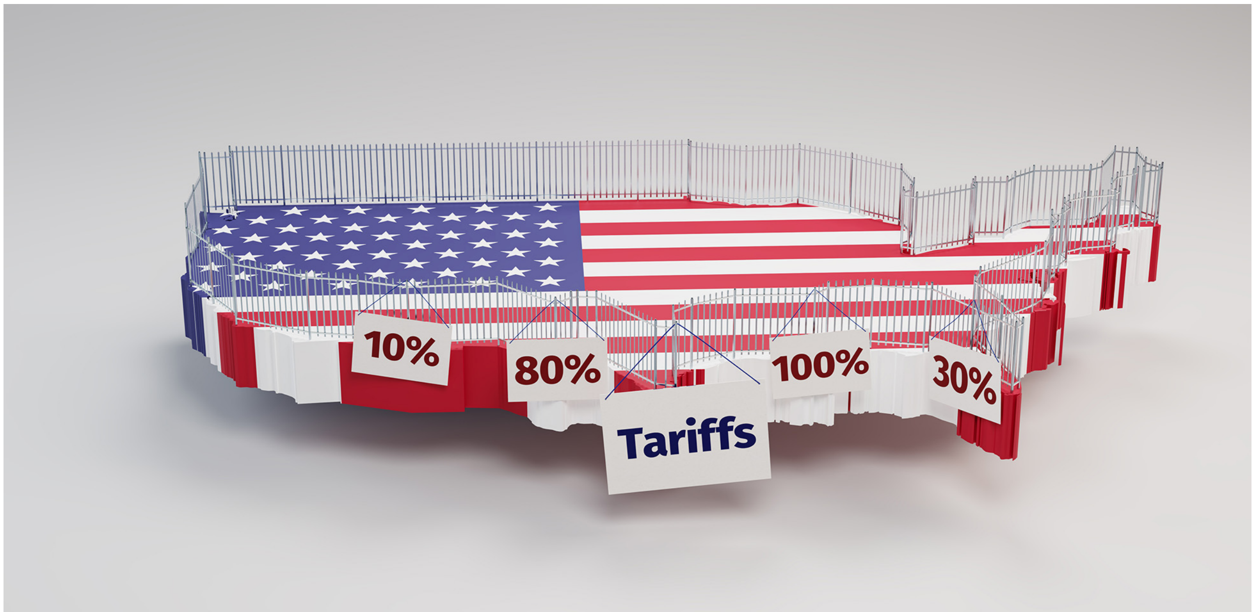
THOUGHTS FROM THE FRONTLINE

Revenue Thoughts

By John Mauldin | February 22, 2025



Highly Tentative Baseline Estimates
Unpredictable Things
Gargantuan Change
West Palm Beach, Dallas, DC, and Fishing

Last week we began discussing the import tariffs President Trump has been threatening. Most (China is the exception) have not taken effect yet. It's possible they will never happen or will be quickly modified or rescinded as happened in Trump's first term.

Real or not, the fact these tariffs *might* happen affects business and consumer confidence, which in turn affects the economy in broader ways. I showed last week how uncertainty surrounding growth and inflation was already high. Adding possible tariffs to the outlook is a further complication—and, in my view, an unnecessary one.

BUT… my view, like yours, is restricted. None of us outside Trump's inner circle know what the real goals are. What looks like needless chaos might lead to benefits that outweigh the costs.

One potential benefit is revenue. Could the tariffs produce significant tax revenue that would help reduce the federal debt? The president seems to think so. He's said it many times, often referring to the McKinley era when tariffs represented almost all the government's tax revenue.

In the current situation, we obviously need all the revenue we can get. But ***every*** kind of tax has side effects. The goal should be to create a fair system that produces the necessary revenue at the lowest possible cost for the economy.

Could import tariffs be part of a new system that better accomplishes these goals? I would have once called this unthinkable. But we've reached a point with deficits and national debt where we must think the unthinkable. Everything has to be on the table.

But putting everything on the table doesn't mean everything *stays* on the table. It just means every idea should get a fair look. That's what I'll try to do today.

But before we jump into that, I need to do something that I've not done in 25 years of writing this letter. I am going to have to throw the flag on myself (or for the rest of the world either a yellow or red card). I suppose we could call it 15 yards for unnecessary data sourcing or perhaps roughing the data—data sourcing interference by the offense? I was rightly called out by multiple scores of readers for using uncorroborated data when talking about government spending. You were right. There was enough verified data from government sources on fraud and overpayments that I didn't need to go there. It obscured the point I was trying to make and unnecessarily called the entire premise into question. I want to thank readers for their sometimes not so gentle feedback, because I deserved it. And you deserve better. I ***will*** do better.

I would actually prefer never to visit the intersection of politics and economics ever again, but I'm afraid with the current administration that won't be possible. We have to deal with what's happening in the real world. Sigh. And disagree when appropriate.

Highly Tentative Baseline Estimates

If tariffs are to be part of the revenue mix, we need to know how much they can contribute, and at what cost to the economy. Unfortunately, any answer is necessarily filled with assumptions. And you know what they say about assumptions.

The first problem is we don't know which countries and products would be tariffed, and at what rates. Even if we knew, there is no guarantee it would stay the same for long.

If the tariff plans were coming from Congress, there would be a long guessing game while they negotiated a bill. Then we would have clarity (for better or worse) once something passed. That's not how this is working. The president is using presidential authority that gives him wide latitude to do whatever he wants *and* to change course as events unfold. This has some advantages, but it creates even more uncertainty.

But let's assume Trump settles on a tariff scheme and then leaves it alone. Predicting its effects would still be hard because we can't know how other countries would react. Nor would we know how American companies and consumers would respond. This is Game Theory 101. The world was at an equilibrium. Whether it is a fair equilibrium is beside the point. The equilibrium exists. When one player changes the rules all the other players will adapt. The first player can try to guess what the other players will do, but he has no control over it. This makes assumptions particularly difficult.

Nonetheless, without *some* kind of baseline estimate, it's hard to even have a conversation. Several organizations have been trying to crunch the numbers and show what may happen. I'll review a few for you. Just recognize the limitations. As you will see, the estimates are all over the board.

The Budget Lab (TBL) at Yale issued a report last week on Trump's idea for a "reciprocal" tariff regime. This would involve raising the tariffs on a country's exports to the US to match whatever rate it charges on exports from the US. In practice, this would mean large tariff increases on most imports, since many other countries charge US exporters far more than the US charges them.

The TBL study estimates this plan would produce $3.5 trillion in tariff revenue over the next 10 years, assuming other countries didn't retaliate. In an alternate scenario assuming retaliation, it would be more like $2.7 trillion. However, those numbers are "conventionally" scored. A "dynamic" analysis that includes likely effects on GDP growth would reduce revenue by $200–400 billion over the 10 years.

Again, all this is highly tentative. *If* it is correct, and *if* that kind of scenario were to actually happen, the Treasury would get additional revenue of (worst case) roughly $227 billion to (best case) $350 billion annually, on top of income and other taxes. Those are big numbers. Not big enough to balance the budget on their own, but enough to make a difference.

Another study by the Tax Foundation looked at a "universal baseline tariff" plan—essentially a 10% or 20% across the board tax on all imports. They estimate a 10% universal tariff would raise $2 trillion over 10 years, while a 20% universal tariff would raise $3.3 trillion, when conventionally scored. Dynamically scored to consider likely economic effects, the revenue estimates are $1.7 trillion and $2.8 trillion, respectively.

As in the reciprocal tariff plan, the universal baseline idea produces significant revenue, but is not alone sufficient to balance the budget or offset the other tax cuts Congress is presently considering. It would help, though.

One more example: The nonpartisan Committee for a Responsible Federal Budget (CRFB) looked at the new 10% tariff Trump announced on China, which took effect on February 4, and the 25% tariffs on Canada and Mexico which are on hold until March.

The CRFB estimate shows the China tariff would generate a total of $200 billion in 2025–2035. The 25% rate on Canadian imports to the US (with a lower rate for certain energy products) would produce $500 billion over the 10 years, while the Mexico tariff would yield $750 billion. On a dynamic basis, the three would combine for $1.3 trillion over the 10 years. Or about $130 billion a year.

Unpredictable Things

All three of those tariff plans are quite aggressive. They would surely have serious side effects, if enacted. Global trade is an incredibly complex, interconnected web; unpredictable things can happen once you start unraveling it. Does the estimated revenue justify those risks? It's hard to say. But I personally think the unintended consequences will be significant. Like the first term, that will likely mean a lot of adjustments. As I pointed out last week, tariffs on autos are very complex and could result in much higher new car costs, which will eventually mean higher used car costs. Unless there are exemptions…

Let's also note that raising revenue isn't the only reason to consider tariffs. Remember where all this started. The US decision to normalize trade with China by allowing them into the WTO wreaked havoc on parts of the US manufacturing sector, putting many out of work and launching a variety of social consequences. Yes, we got lower consumer goods prices in return, but this was a cold comfort to many suffering Americans. And our government did little to help them.

Sidebar: Today the US manufacturers more goods than it ever has, it just does it with fewer workers. While it is convenient to blame manufacturing job losses on China or Mexico or another country with lower labor costs, productivity-enhancing technology has also been a very large factor in the loss of manufacturing jobs. With the expected growth of the robotics industry over the next decade, this is going to become even more evident, which is why some people with the economic understanding that God gave a goose suggest that we should tax the use of robots. Back to the main story…

In short, we failed to anticipate the side effects or make plans on how to handle them. That was a mistake some think we should correct. Furthermore, the COVID period demonstrated the very real risks of being dependent on foreign sources for important goods. China's geopolitical ambitions also make it unwise for the US to rely on a potential adversary.

Further, it's not as if we don't already have a lot of tariffs. According to *The Economist*,

> "America already levies taxes on a vast range of goods brought into the country. Its harmonized tariff schedule has 13,000 categories, from 'artificial flowers, foliage and proven parts thereof' to 'swords, compasses, bayonets, lances and similar arms.'
> If America decides that fairness means going tariff for tariff with all 180 or so trade partners, enacting that would produce around 2.3 million individual tariffs and result in outsourcing its trade policies to countries with entirely different industrial structures and interests."

As they point out, the mass confusion would border on the absurd. So any tariff would pretty much have to be across-the-board or very limited.

It's not easy. Columbia has a 70% tariff on coffee imports to protect its coffee industry. Putting a 70% tariff on coffee coming into the US wouldn't create a coffee industry in the US (with the acknowledged exceptional coffees of Hawaii and Puerto Rico).

Torsten Sløk points out that if you wanted to replace the income tax with tariffs as in the McKinley era, rates would probably need to be around 200%. On everything. He notes that would be inflationary. I would add that even a 20% tariff will be inflationary.

I think it's pretty clear Trump wants the Federal Reserve to cut rates. However, even if tariffs only raised inflation by 1 or 2 tenths of a percent, it's still the wrong direction. That might be offset by the deflationary impact of fewer federal jobs. Or not. It gets murky very fast.

Let's note, though, the impact on American jobs would be important even if tariffs raised no revenue at all. In fact, "no revenue" might be the ideal outcome in the minds of many people (not mine!) if it meant Americans had stopped buying foreign goods because we had reasonably priced domestic substitutes. But as of now, our economy isn't able to deliver any such thing.

Further, it matters which particular goods we are talking about. You've heard of "comparative advantage," the Ricardian classic theory that every nation is better off if it concentrates on doing what it does best and importing the things it can't make cost-effectively at home. This idea has limitations, but it's generally right.

The US, for all our problems, still has a large, dedicated, and educated labor force. We're good at technology and sophisticated manufacturing. Others are better at labor-intensive, repetitive kinds of production—textiles and apparel, for instance. That's the basis for a win-win relationship.

If tariffs are the kick everyone needs to change direction, then I can see them as a temporary measure. But making them a permanent pillar of the tax system is risky and unnecessary. There are better ways to get the revenue our government needs.

Gargantuan Change

An old political rule sounds trite but really works:

- If you want more of something, subsidize it.
- If you want less of something, tax it.

Under our current system, we primarily tax income, thereby discouraging something we should reward. Pretty much every economist who has ever studied this says it makes more sense to tax consumption.

Import tariffs are a kind of consumption tax, but not a well-designed one. Because domestically produced goods are exempt, tariffs simply shift consumption. Indeed, that's their goal, as discussed above. But a better consumption tax would encourage people to spend less and save more.

Longtime readers know that I advocate a Value Added Tax, or VAT system. Almost every country other than the US uses the VAT. Some combine it with an income tax on higher-earning people. The particular parameters vary but it is essentially a sales tax applied at all levels of production.

I always get pushback when I talk about a VAT, for reasons we will discuss below. This time I will offer a way to fix those very real concerns and problems.

As far as I can tell, I first mentioned the VAT idea in this February 2012 letter. I cited an idea Larry Lindsey and Marc Sumerlin offered in their 2008 book, *What a President Should Know*. Here's how I described it.

> "What they suggest is to tax consumption with a 20% Value Added Tax (VAT). There would be no taxes for incomes under $100,000. None. No Social Security. No Medicare. If you make less than $100,000 you pay nothing.
>
> "All income over $100,000 is taxed at 20%, no matter what the source. No capital gains rate or dividend break. I assume that also means no municipal bond exemptions. No exemptions for anything. Every last tax expenditure goes away. Corporate tax rates would be 20%, and again I assume no exemptions. If you make a profit, you pay taxes.
>
> "Although they did not say it in the book, they essentially agree with Hobbes that income measures what you contribute to society and spending measures what you take from it.
>
> "What society wants (and needs) is more income, as that grows tax revenues and general wealth. Consumption—what you get from society—is taxed. We don't just need to tax millionaires more, we need more millionaires that we can tax. And you get that by encouraging growth in the economy.
>
> "They also note that their proposal was revenue-neutral in 2007, and included a $2,000 per child tax credit. Every worker would get an approximate 7.5% pay raise from the removing of Social Security and Medicare taxes. While businesses would also get that same tax break, they would have to pay a VAT on salaries, which would be an increase in cost. Welfare, the social safety net, and health care would all be funded.
>
> "As the VAT would not be paid on exports, it would put us on a more even ground with those nations that have a VAT and certainly lower business taxes, both of which would make us more competitive and increase exports and thus employment.
>
> "One can adjust the levels of both the VAT and income taxes to match the desired level of government spending. I might prefer less, but that is not the point here. Match these taxes (along with the normal excise taxes) with entitlement reform, a properly structured health-care system, and some cuts in other areas, and you are close to a balanced budget."

(I know you're wondering so I'll save you the math: $100,000 when they finished the book in 2007 is equal to about $153,000 today. And the VAT rate would have to be higher because of the increased expenditures. Income taxes might have to be adjusted as well. There are literally scores of ways you can play around with this.)

Would a 20% VAT really raise significant revenue? Roll forward to my 2023 [*Time to Consider a VAT?*] letter. I noted a 2022 CBO report analyzing a possible 5% VAT, estimating it would raise $338 billion yearly. But that was for a 5% rate that excluded about 40% of household consumption. A 20% rate on a broader base would obviously raise $2 trillion+, along with a still-large amount of revenue from corporate and income taxes. And the various distortions and perverse incentives of the income tax system would be greatly reduced.

Combined with true spending reform, I think a system like this would go a long way toward solving our fiscal ills and enable more sustainable economic growth. There are two big barriers.

- First, the transition would have to be planned carefully to let everyone adjust. It would probably need to be phased in over several years.

- Second, the plan would have to address the legitimate fear that the income tax part would get expanded under later administrations, leaving people paying more than were under the old system. I would suggest that the entire scheme only pass IF a constitutional amendment passes requiring a 60% vote in both the Senate and the House to raise the income tax. No amendment, no VAT.

We don't have to balance the budget to make the bond market go back to sleep at some future crisis. We simply have to get the deficit substantially below nominal GDP (today that would mean about a $1 trillion deficit), keep tight control over government spending, and over time we could grow our way out of the debt crisis.

You might call this a completely unrealistic pipe dream. I get it. And today, it is. But when we are faced with a debt crisis around the end of the decade, we will need solutions. Everything will be on the table. Those who oppose a VAT must offer their own alternative. It can't simply be "cut entitlements" because that will get nowhere close to majority support, and will be overturned when the next Congress is elected. Cutting entitlements is a death sentence for reelection. Good bad or indifferent, entitlements are here to stay. (Reform them? Absolutely.)

Absent a shift, we will be forced into some kind of budget compromise in the crisis that I believe is coming. It will be a gargantuan change to the planet's largest economy, not to mention the reserve currency. It could go badly wrong if we don't get it right. As I keep saying, we are past the point of having easy choices. Anything we do is going to hurt.

I highly doubt anything like this is on Trump's radar screen, but it should be. He may actually be the only one who can do it. Just as only Nixon could go to China, maybe only Trump can fix the tax system. And tariffs are just tinkering around the edges.

One last thought. This is not doom and gloom. I think it is just realistic. It is also very possible that proper planning can keep you and your family economically viable through this crisis. The important word in that last sentence is *planning*. *Stay tuned…*

West Palm Beach, Dallas, DC, and Fishing

Shane and I will be in West Palm Beach soon to meet with friends and for a client dinner with David Bahnsen of TBG. I expect to be in Dallas where we will open our first clinic focusing on Therapeutic Plasma Exchange, then to DC for a political event in April and opening another clinic. I will visit other cities this year as we open clinics. As those dates firm up, I will let you know here.

Shane and I will once again be joining readers at the West Coast Fishing Club in far northwest British Columbia. Last year we had 30 readers, most of whom are coming back as the experience was just a true bucket list event. There will be a few slots open and I will provide a link next week. It will be first come first served.

I am working with Ed Easterling to update the chart that we did in *Bull's Eye Investing* over 20 years ago and will feature it in this letter within the next few weeks. There are some rather interesting new implications.

And with that, I will hit the send button and wish you a great week. And don't forget to follow me on X!

Your paying attention to his data sources analyst,

John Mauldin
subscribers@mauldineconomics.com