

Replacing Taxes With Tariffs

Last week, Donald Trump proposed replacing the income tax with a tariff on imports. Washington DC let out a loud, and collective, scoff. The average American was intrigued. More on this in a few...but to be clear, the idea as it stands won't work in our current system. The US cannot replace income tax revenues without sky-high tariffs, and sky-high tariffs would shut down world trade. Remember...much lower Smoot-Hawley tariffs in 1930 helped kick off the Great Depression.

But that doesn't mean we shouldn't use this as a starting point for discussion. Have you followed Elon Musk and SpaceX? Specifically, the Starship, which just had its fourth launch? Well, what we are witnessing is the process of iterative development. Each launch has gone further and had more success. Henry Ford did the same thing with the automobile and assembly lines.

This process of iterative learning, which is prevalent in the private sector, seems non-existent in government. To use an example that writer Glenn Harlan Reynolds shared in a recent Substack post: *Ad Astra, Per Ardua*, the Space Shuttle was supposed to be reusable, but it never truly was – it cost over \$1 billion per flight. Musk, on the other hand, by figuring out how to re-use boosters has driven the cost per flight down to the range of \$3-5 million.

The cost to put a kilogram of payload in space was \$55,000 in the Shuttle but is only \$2,700 in a SpaceX Falcon 9, a 20-fold reduction. And this cost will keep coming down. It's an amazing thing to watch, how the private sector can simply crush government in efficiency and progress.

Which takes us back to Donald Trump's proposal to scrap the income tax and replace it with tariffs on imports. If you look at this proposal like the permanent fixtures of the Beltway do, it's absolutely ludicrous. Paul Krugman (on X) couldn't resist running all the numbers, showing how the tariff would have to rise to 133%, or higher, to raise the same revenue.

At least he admitted that in the 1800s the US funded itself with tariffs and excise taxes, but that was when the federal government was significantly smaller. Instead of wondering if we could run the government like SpaceX, and not NASA, he just said anyone who thinks we can shrink government that much is just plain "ignorant." For the record, calling people ignorant is not proving them wrong. It is rude, though.

Krugman comes from the left, but even those on the right said Trump's idea was crazy. Most used the same logic as Krugman. Inside the Beltway, the only way to look at anything is to use static scoring models, and very little imagination. Social Security can't be imagined anew, bureaucracies are entrenched and have decades of momentum. They have no incentive to become more productive or to learn iteratively. Doing so means fewer jobs and smaller budgets. There is no profit incentive at all...government cannot possibly think like the private sector, even though it should.

At least Donald Trump is thinking outside the Beltway Box. The pundits are right, taxing just imports would increase the deficit "hugely" to use his word. We have no idea if that's what he was thinking. We doubt it, but it takes an idea to lead to iterative thinking. Science fiction writer, Steve Stirling, wrote about Starship: "That's what iterative development does; you don't try to make it perfect the first time. You make it 'good enough for a first try', push it until it breaks, fix what broke, try again, and again and again... until it works all the way."

One could argue that government keeps trying to iteratively learn. But Great Society programs have led to several generations of welfare and apparently permanent poverty. Programs to fix inequality led to more of it, public schools (especially in inner cities) have failed, Social Security will run out of money in 2033, the Federal Reserve has a \$1 trillion loss on its books and has to borrow money to make payroll. The government is so big that even Sports Illustrated, ESPN, and the Weather Channel can't help but talk about politics.

The problems the US has today are no different than the problems the US had in the 1960s or the 1930s. One could actually argue that they are worse even though government has grown and grown. So, this proposal by Donald Trump is a breath of fresh air. Instead of immediately declaring it dead-on-arrival, why don't we take this opportunity to discuss the size of government, and how we pay for it.

We know it's more comfortable for the Beltway crowd to just move on...don't rock the boat...analyze the same things the same way as always. We, on the other hand, are going to take this opportunity to grab this idea by the horns and discuss it in the context of history, and the current state of affairs in the US.

The Founders did not have an income tax to fund government, that wasn't instituted until 1913. What they could do was use excise (sales) taxes and tariffs. In the 19th century, actually up through 1930, the peacetime government spent less than 3% of GDP. Today, federal spending is roughly 23% of GDP, while state and local governments spend about 14% of GDP on goods and services. Add in the cost of complying with government rules and regulations and we estimate the government either spends, or directs to be spent, roughly 50% of our annual output.

The private sector can't afford it...that's why federal deficits alone are running nearly \$1.7 trillion per year, with no end in sight. State debt and unfunded pension liabilities have also grown exponentially. Clearly something is broken, but bureaucrats, lobbyists, politicians, and think tank employees go to work every day and color inside the lines. Every once in a while someone comes up with a new idea, which immediately gets crushed by vested interests.

A couple of things. It is clear China has used existing tariffs and global trade to dominate markets in all kinds of areas. The US would have a tough time, today, producing all the pharmaceuticals, ammunition, batteries, and many other items it needs without trade. We believe trade is a positive for economic growth; we are free traders. However, we are also realists that understand not all our trading partners have our best interests at heart. Counting on imports for our national security is a risk that few talk about.

Second, roughly 40% of Americans don't pay income taxes. The income tax system has become so progressive that 97.7% of the taxes are paid by the top 50% of income

earners. In other words, half of America has no, or little, skin in the game when it comes to income taxes. As a result, top tax rates (along with deductions, etc.) are likely higher than they would be if everyone paid the tax. When there is no pain to you why care what others have to pay? And to all those who say tax rates don't matter, just look at all the people and businesses leaving California, Illinois, and New York.

A tariff is a tax on consumers because it will be passed on. In other words, it's a form of a consumption, or sales, tax. Just about every state has one. So, this idea to replace income taxes with tariffs is a step toward a consumption tax. Some say this tax is regressive because low-income earners spend more of their income than high income earners. But this can be dealt with and, don't forget, high-income earners (or their heirs) eventually spend their savings and therefore pay consumption taxes in the future. If everyone has to pay, then maybe voters will look differently at how government spends.

It seems clear that if we step back, look at the size of federal, state, and local government debts – the fact that after trillions in spending we have not really improved poverty, nor have we addressed the inefficiencies in government – the system is broken. Maybe some kind of iterative process of change is the only way to break the cycle. As a result, we think immediately scoffing at a new proposal is wrong.

We rarely write more than one page but found this idea to be so amazingly new that we couldn't help it. It is time for America to have a discussion about how much it spends and how it pays for it. Maybe, just maybe, Donald Trump has started that discussion. If so, we will be better for it.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-17 / 7:30 am	Empire State Mfg Survey – Jun	-10.0	-18.6	-6.0	-15.6
6-18 / 7:30 am	Retail Sales – May	+0.3%	+0.4%		0.0%
7:30 am	Retail Sales Ex-Auto – May	+0.2%	+0.6%		+0.2%
8:15 am	Industrial Production – May	+0.3%	+0.3%		+0.3%
8:15 am	Capacity Utilization – May	78.6%	78.6%		78.4%
9:00 am	Business Inventories – Apr	+0.3%	+0.3%		-0.1%
6-20 / 7:30 am	Initial Claims – Jun 10	235K	235K		242K
7:30 am	Housing Starts – May	1.370 Mil	1.370 Mil		1.360 Mil
7:30 am	Philly Fed Survey – Jun	5.0	0.8		4.5
6-21 / 9:00 am	Existing Home Sales – May	4.090 Mil	4.130 Mil		4.140 Mil