EconoFact Chats: Dissecting the Budget Bill
William Gale, The Brookings Institution
Published on 6th July 2025

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I'm Michael Klein, executive editor of EconoFact, a non-partisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
All right, welcome everybody to the third EconoFact Ask Me Anything webinar. We're really pleased to have as our guest today Bill Gale. Bill is in the Economic Studies Group at the Brookings Institution. He's the Arjay and Frances Fearing Miller Chair in Federal Economic Policy, and he's also the co-director of the Urban-Brookings Tax Policy Center. Bill has written quite a few memos for us at EconoFact, and he's been the guest a number of times on our podcast series. So Bill, thanks a lot for joining us today.

Bill Gale
Thank you for having me. Always a pleasure.

Michael Klein
So, obviously, there are a lot of federal budget issues in the news these days, as the House has just passed the President's policy bill…tax policy and spending bill. How will this new bill that was passed by the House, and now it's going to the Senate, as it's constituted now, before the Senate changes it, how's it going to change the taxes paid by people at different levels of income?

Bill Gale
Wow, it's a huge bill. It's got, I would say, three or four major components to it, and I have to explain that before I get to the actual answer. One component is that the income tax provisions and the estate tax provisions that were enacted in 2017, in the Tax Cuts and Jobs Act, were all made temporary, and were supposed to end at the end of 2025. This bill makes them permanent…would extend them permanently, and it expands some of the provisions as well, so it doubles down on the income and estate tax cuts in 2017. It restores a number of the business provisions that were originally in the 2017 cut but then were phased out over time. This bill would restore them to their 2018 values, to what was passed in 2017. That's all sort of TCJA (Tax Cut and Jobs Act) on steroids. The third component is a number of the President's campaign promises; no tax on tips, no tax on overtime. The President proposed no tax on Social Security, but that would be enormously expensive, so there's an increase in the standard deduction for people over 65, and there's a few other provisions that come out of what Trump said while campaigning. And then the fourth component is what are called pay-fors, which are tax increases that go after groups that, essentially, you would think of as Trump administration enemies – so, immigrants, low income households, universities and foundations, clean energy – a lot of stuff like that, that are are either revoking previous tax cuts or imposing new tax cuts. When you put that all together, it sounds enormously confusing, and of course it's a sprawling omnibus kind of bill. When you put it together, especially with

the cuts to food stamps and Medicaid, a pretty clear picture emerges that high-income households are going to get very large tax cuts. Low income households are not only not going to get very big tax cuts, their after tax income or their after tax resources are actually going to go down as a result of the a variety of changes in the tax law proposed in the bill, and the changes proposed to food stamps and Medicaid. So on an overall basis, there's an enormous amount of things going on, but your question sort of cuts through that and the answer, at least I hope, highlights the point that this is a very regressive tax bill. It would make low income households worse off. It would make high income households much better off.

Michael Klein

So following up on that, Bill, how unusual is this compared to other tax changes that we've seen? You sort of alluded to the fact that it's very political. Is that something that we typically see when there are big tax changes, or is this really sort of sui generis, and we haven't seen a big tax bill like this that was so blatantly political?

Bill Gale

Yeah, blatantly political is in the eyes of the beholder. Certainly, Democrats thought the 2017 tax cuts were blatantly political. Republicans probably thought that the IRA, the Inflation Reduction Act from a few years ago where all the Clean Energy Credits came from, had a political bent. I mean, I don't think the bill is that much of an outlier. Well, let me take a step back. Both of those bills, 2017, and the IRA provision, I think was 2021, were passed in situations where one party had control of the White House and both houses of Congress, and that's the situation we have now. So in that sense, it's the same. The way that is different is just the way the whole administration is different, and it feels like there's more of a vendetta against political enemies, rather than simply pursuing the goals that the party empowered would like to see implemented.

Michael Klein

So, I'd like to follow that up with a question from one of the attendees. You're alluding to the fact that tax policy is inherently political, and these are choices that are being made for a particular party's view of how the world should work, or who should gain and perhaps who should lose. One of our attendees sent in a question earlier: if a large majority of mainstream economists were able to determine the US budget and tax policies, what are the top three to five priorities, where to invest, where to cut back, and what kind of tax system to have? So, if we don't think about rewarding your friends or punishing your enemies, what would be sort of more, one could say, politically neutral to have the goals of efficiency and good revenue collection, and having fewer distortions?

Bill Gale

Oh, this is a great question. The economist Alan Blinder, who's at Princeton but also served time at the Fed and the Council of Economic Advisors, he once said that economists are most ignored on the issues that they most agree on, and they're given the most attention on the issues where they disagree the most. So if economists were in charge, you would not have tariffs, that's for sure. I believe that economists would support raising taxes on consumption, for example, via value added tax, which exists in every advanced country except the United States. I think you'd see a carbon tax with a classic externality, where you want the producers and consumers of carbon to face the full social costs of their activities. You would not have a mortgage interest deduction. You'd probably get rid of a whole lot of deductions and

exemptions. I think you keep the earned income tax credit, you keep the charitable contributions deduction, or something like that. But other than that, I think you'd sort of clean out the stable, if you will, on the dozens or hundreds of special rules would go away. That would generate a significant amount of revenue, some of which would go to deficit reduction, some of it would go to lowering the tax rate. But broad base, lower rates, consumption tax, carbon tax, I think a policy like that would generate wide consensus in the economics world.

Michael Klein
So you said cleaning out the stables, which is a Herculean task.

Bill Gale
Yes.

Michael Klein
So, I guess it would be quite difficult to do that. If we were less ambitious and just think about some of the biggest loopholes in the tax system, which of these are the ones that you think are particularly unfair and inefficient and you'd like to see eliminated, if possible?

Bill Gale
In the existing system?

Michael Klein
Also, perhaps, in what's being proposed in the new bill.

Bill Gale
Sure, let's talk about what's being proposed first. There is absolutely no reason in the world to provide income tax exemption for tips. A very small percentage of low-income workers earn tips, and the exemption, I think the rules are up to $160,000 in income in industries where tips are common, so that requires some interpretation. But there's just no reason to do that. It's an answer in search of a question.

Michael Klein
Let me just say that you have a very nice memo on EconoFact about that, and goes into some detail about that.

Bill Gale
Yeah, no one ever thought about a tax on tips until President Trump was trying to win Nevada in the general election. I think generally, the hidden tax rates that…Congress has been very reluctant to raise the headline statutory tax rate. So instead, it imposes these limitations on itemized deductions that phase out with income. That phase out is, in itself, a higher marginal tax rate. So, those are just some of the issues. But broadly, most of the deductions are there, or exemptions or credits are there for political reasons. The way I would see it would be to start over, have a standard deduction, give people a deduction for charity, subsidize low income work, and have a progressive rate structure. I don't think the top rate is excessively high, but if someone wanted to lower it a little bit, I wouldn't mind, as long as we're bringing in extra

revenue from consumption and carbon taxation.

Michael Klein
You know, when we're thinking about this, what struck me when I started to learn about this, because I was doing EconoFact and sort of went beyond what my narrow field of research had been, was the Step-Up deduction – when somebody dies, and then the heir does not pay the capital gains, right?

Bill Gale
Right.

Michael Klein
That strikes me as a particularly unfair and inefficient loophole in the system. Would you agree with that?

Bill Gale
Yeah, in fact, I've written on that. I've called that the biggest loophole in the whole system, followed shortly by the 199A business deduction. But the Step-Up in Basis is problematic for many reasons. It loses a lot of revenue. It encourages people to hold on to assets long after they should. It's just patently unfair that the income never gets taxed, but it can be an enormous amount of income. So I think that that is, again, I have referred to that as the biggest loophole in the whole tax system. And I think that's accurate.

Michael Klein
What about the mortgage interest deduction?

Bill Gale
That's an interesting one. Normally, in an income tax, people would be allowed to deduct the costs of earning income. So, if you have an asset and it's generating income, and you borrowed money to finance the purchase of that asset, you would be able to deduct the interest costs as a cost of earning income. The problem with doing that with the mortgage interest deduction is that people are not taxed on the income that they generate from their house. You might say, well, they're taxed on capital gains, but that's different. If you live in a house, you're essentially paying yourself rent. Think about it: if two people each own a house and they live in each other's house, then they pay rent to the owner, and the owner has to declare that as income. If they live in their own house, they're essentially paying themselves rent and getting income, but that income is not taxed. It's called imputed rental income from owner occupied housing. But if the income is not taxed, then there's no reason to allow a deduction for the cost of earning that income. The true problem with the treatment of housing is that the imputed rental income from housing is not taxed. We're not going to change that, probably, because people would get really annoyed at that change. So, the second best solution would be to not allow the interest deduction, since it's a cost of earning income, but the income is not taxed. So, that's the objection to the mortgage interest deduction, and it's slowly being phased out in two ways. One is the standard deduction is going up, which is making it less attractive for people to itemize their deductions, and the second is to the extent that there are limits on other deductions, like state and local taxes, it becomes less attractive for people to itemize generally. What policymakers haven't done is really go after the mortgage interest deduction itself, but they've gone at it in

some indirect ways.

Michael Klein
So you're a big advocate for cohabitation, it sounds like! We have a question from an attendee, Bill, who said she thought that reconciliation bills were supposed to be budget neutral. So what's going on in this case?

Bill Gale
That's a great question, and 'supposed to' is doing a lot of work in that sentence. Let me take a step back for people who don't know what reconciliation is. Normally, when Congress passes something through regular order, it requires 60 votes to overcome a filibuster in the Senate. The Republicans don't have 60 votes, they have 53, so they're using a process called reconciliation. Reconciliation is attractive to a majority party, because you only need a majority vote, not 60 votes in the Senate, to get it enacted, but it comes with some restrictions. It has to deal with things that are budgetary in nature. So, you can't ban abortion via reconciliation. It's gotta be budgetary in nature. You can't touch Social Security, and it can't increase the deficit after 10 years. And I think that's what their question is getting at. Normally, reconciliation bills, 'normally' emphasise…have to turn off after eight or nine years. That's why the income tax rules and estate tax rules in 2017 were set to expire at the end of 2025. So, reconciliation was originally introduced to make it easier to reduce deficits, but every administration this century has come in with unified control of Congress, but without 60 votes, and every administration has used reconciliation to increase deficits. Now I want to come back to this last point about…according to the so-called Byrd rule, it can't increase the deficit after 10 years. Increasing the deficit requires a comparison with some other measure of the deficit. That is, you need to know what you think the deficit will be if they don't do anything 10 years from now, versus if they do something. And what the Senate is toying with is using a baseline that basically assumes the TCJA tax cuts, the 2017 tax cuts, are already made permanent. So if they did that, they would be able to get around that last provision, because if the tax cuts are made permanent in the baseline, then making them permanent doesn't increase the deficit after 10 years. It's a total…gimmick is too weak of a word. It's an abdication of any budget responsibility, but that's what they're talking about doing. So reconciliation, again, was intended to make deficit reduction easier, but it has been used to increase the deficit in every administration this century.

Michael Klein
So Bill, you know we're talking about the deficit, but in some ways, the real issue is the debt. Can you describe for everybody the distinction between the deficit and the debt…why do we look at debt relative to GDP instead of just a dollar figure, and what are the problems facing a country that has big debt?

Bill Gale
Sure, so the deficit is what economists call a flow measure. It's just the excess of spending over revenues in a given period of time, typically a year. For a household, it would just be how much they spent versus how much they earned, and got in interest income and all that, over the course of a year. The debt is the accumulation of all the prior deficits, and it's measured at a point in time, whereas the deficit is measured over a period of time. So our debt right now is equal to about as large as one year of national income or national output. So you'll hear people talking about debt being 100% of GDP, it doesn't mean all of our GDP is going to debt. It means the stock of debt at a given point in time is about as big as the economy

over the course of a year. The problem with debt is…there's a quote in a Hemingway book where one character asks another, 'how did you lose your wealth?,' and the guy answers, 'two ways: gradually and then suddenly.' That's sort of how debt works. The gradual way is, if the government borrows more, it crowds out investment by firms or forces us to borrow from overseas, which is not bad in itself but it means that we need to pay that back in the future, and that process will erode economic growth by reducing the amount of investment in the economy, or increasing the amount of money that we need to pay foreigners in the future. The 'suddenly' part, which I don't think is particularly relevant for the US but is certainly relevant for the Argentina's and the Greece's of the world, is that if you have a high level of debt, it may spook investors, it may cause kind of a sudden change. In Greece, for example, they were already in a relatively unstable debt situation 20 years ago, and then it was revealed that there had been some gimmickry with the budget and that things were worse than anticipated. And because they were already in a precarious situation, that led to a capital outflow, a spike in interest rates, so it's sort of like tinder on the fire. Again, I don't think that the 'sudden' scenario is a problem for the US. Well, for economic reasons, it's not a problem. We have enough money to pay our debts for decades to come. The risk is more political. For example, if policy makers decide not to increase the debt limit in time and the US defaults on some of its debt, or if the government actually goes through with all these tariffs and self induces a recession, and self induces investors to leave the dollar for other currencies, then those political risks are heightened by the fact that we have a high level of debt. But, I don't think the high level of debt itself will spark a crisis.

Michael Klein

So, I guess there's a thought among economists that countries that borrow in their own currency and have a flexible exchange rate won't face a crisis because there's not a fixed amount like a bond, or an exchange rate that they're fixed to, that can cause a breaking of a contract. That doesn't happen when you borrow in your own currency, and when you have a flexible exchange rate. But we have seen the Treasury market apparently responding to the budget bill now with an increase in interest rates, interestingly at the same time that the dollar is weakening. So if not a fiscal crisis, is this something that is going to badly affect the economy?

Bill Gale

Well, I personally do not believe that…let me take a step back. In recent weeks, as you said, the dollar has gone down in value, and interest rates have gone up. And that's a weird combination, because if interest rates go up, normally you'd think people would plow into US assets, and there'd be bigger demand for the dollar, so the dollar would go up. I don't think that the odd response right now is due to information about the budget deficit, because the House did basically exactly what they said they would do in the budget resolution which they passed a couple of months ago. Go back six months, when President Trump was elected and the Republicans got a majority in each house, you knew they were going to propose to extend the TCJA. That was sort of a lightning rod issue for them. So, there's no new news in the House bill. There's no new news about the deficit. There might be new news about particular features of the bill, like there's a section called Section 899, which is sort of a retaliatory tax against any country that participates in the OECD's pillar one and pillar two. It's not law, it would be something that allowed the Treasury Secretary to make a determination. Markets might be responding to that. But I think they're responding more to the political uncertainty, that the administration could do something quite damaging in order to make some point or hit some ideological goal. I think markets are responding to this

political risk rather than responding to the deficit information, because the deficit information is not new, and bond traders look ahead to see what's coming down the pipe.

Michael Klein

So, Bill, as always you did a really great job of taking very complicated issues and making them understandable in a very clear way, and also pointing out why these are very important issues. So, thank you very much for being a guest on this Ask Me Anything webinar, I really appreciate it.

Bill Gale

Thank you, I appreciate the opportunity.

Michael Klein

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