Transcript

The Bill Walton Show

Adam Michel-Rachel Greszler

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Bill Walton: Hi, I'm joined today by Rachel Greszler and Adam Michel who are both with The Heritage Foundation. Rachel researches, analyzes taxes, Social Security, disability insurance and pensions to promote economic growth. Adam focuses on tax policy and a federal budget as a policy analyst at Heritage and he focuses on the economics of taxation, international tax competition and the federal budget.

We're here today to understand the recent bill that's come out of the House called the Tax Cuts and Job Act, and together we are going to try to understand what it is, make it interesting and have us all know what's at stake for ordinary Americans, so welcome, guys.

Adam Michel: Sounds like quite the task.

Bill Walton: Well, at least we'll make it fun. Adam, tell us what this bill is about and what's in it and ...

Adam Michel: Yeah, well, thanks for having us on. The bill does a whole lot of things, legislative taxes, over 400 pages long and the House is attempting to correct many different problems in our tax codes. We know it's incredibly complex, the current tax code is, it's a burden on individuals and businesses and this legislation aims to address some of those problems. Most importantly, legislation fixes our business tax environment, especially on the corporation side.

Currently, we have the highest corporate tax rate in the developed world at almost 40 percent when you add in-

Bill Walton: 35 percent federal and average states, five percent.

Adam Michel: It lowers that rate to 20 percent, which is what drives this package as being pro-growth. That's the piece that will get businesses to come back to the United States, add additional jobs, add to economic growth and then, paired with that, there's a whole bunch of changes on the individual side. The tax code lowers, consolidates tax brackets, we currently have seven, they move to four.

There's a doubling of the standard deduction, which simplifies tax paying for a lot of average Americans and then they make some changes to past-view businesses, or what a lot of people think of as small businesses. They try to provide a tax cut there, capping the rate at 25 percent but add in some additional complicated rules that make that a less straightforward part of the tax reform.

Overall, the tax packages is definitely a step in the right direction. It's pro-growth, it's pro-worker and so we'll see how it evolves through the process but right now it's in the House of Representatives.

Bill Walton: Rachel, what are the key pieces of the individual side?

Rachel Greszler: The big things there, Adam mentioned the doubling of the standard deduction, so you now have it that individuals won't be taxed on the first 12,000 dollars of their earnings. This is assuming they don't itemize, and married couples, the first 24,000. That kicks up, then you also have the rates. The rates have come down, we used to have anywhere between 10 and 39.6 percent. There are now just four rates, there was three, we hoped, but it went to four.

You start with a 12 percent rate, 25 percent rate and then a 35 percent rate and then they did last-minute add back in the current 39.6 percent rate. On the top, there's not really a rate cut and we can talk about this later, but there's also a bubble rate that actually gets the top rate to 45.6 percent

Bill Walton: Where would we be without a bubble rate?

Rachel Greszler: Back in '86. The rates particularly on the lower-middle income families have come down and they've also shifted the brackets a little bit, so a higher portion of your income is subject to that lower rate. On the upper end, the 35 percent rate, the 39.6 percent rate, those have shifted up a little bit. I guess, just the 35 percent rate. You have the case that people making under about 200, 250,000, they're going to see a tax cut, they're going to be subject to a lower marginal rate but there's going to be a big chunk of income in there between about 200 to 500,000 where they're actually going to have a higher marginal rate than they previously did.

That's one of the downfalls that is on the individual side. Your marginal rates matter so much because that's changing the incentive with the margin. Do I work more, do I invest more, do I grow my company, create more jobs? That's all what the marginal rate has the biggest impact on. You haven't done a lot where most of the economic activity is occurring in the economy there.

Bill Walton: Now, are there going to be more people that pay taxes because of this bill, or fewer?

Rachel Greszler: We were just discussing this. I think that you'll have a small decline in the percentage of Americans that are paying federal income taxes. That's probably, largely, going to come from the child tax credit, which was increased from 1,000 dollars to 1,600 dollars. We have the doubling of the standard deduction, but that's coupled with also eliminating the personal exemption.

Those two mostly wash each other out, it depends on how many are in your family. It could actually be a tax increase for very big families, tax cut for lower ones. Then when you add in that child tax credit, it's 1,600 dollars now instead of 1,000, you're probably pushing some more people off the tax rolls at the lower end.

Bill Walton: Most people are paying payroll taxes, so on and so forth. Many people are not paying federal income tax, and what is that? 45 percent of Americans are not in the tax system-

Rachel Greszler: Yeah, that's about right.

Bill Walton: This brings it to what?

Rachel Greszler: We don't have a good estimate.

Bill Walton: You're not sure yet. We're also not fully baked yet.

Rachel Greszler: It could increase over time depending on some measures, inflation parts could bring it back.

Bill Walton: In my perfect tax world, we'd be broadening the tax ... so more people have a stake in the system and I think one of the flaws we have is that we're cutting taxes but then for half of America it doesn't really matter because they're not part of it.

Adam Michel: This is part of the box that Republicans have put themselves in. One of the two big goals of tax reform that have been pushed is both the business reform, lowering the corporate tax rate to 20 percent, or what we'd hoped would be 15 percent, but then also this idea that we have to provide significant tax cuts to the quote-unquote "middle class." That's a great talking point but actually doing that is more difficult than one would think it should be.

Just because of this 50 percent of people already don't pay a lot of income tax and then the fact that the top 10 percent of income earners pay 70 percent of the income tax. Anytime we're talking about reforming the income tax system, we have to, at some degree, be talking about bringing down those top rates as well. Moving around those pieces, trying to provide a big tax cut for folks that already don't pay a large share of the total income tax becomes hard as you move those pieces around.

Bill Walton: If you're not paying much in, it doesn't matter.

Adam Michel: Exactly. If you're trying not to provide a big tax cut for the quote-unquote "rich," you are out of options. You have taken things off the table that should still be on the table.

Bill Walton: You didn't say this, I said it, but it seems like we're still in the class warfare mode where you've got to soak the rich if you're going to have a tax system.

Adam Michel: That's what's unfortunate about leaving in the top 39.6 bracket, is even though the income brackets were moved up to 500,000 or one million if you're a married couple, leaving in that bracket has real economic consequences. The people that are most sensitive to those high marginal rates are the most wealthy, the people that can choose to retire or to work less, scale back how much they work.

It does have work incentives, it changes savings behavior and investment behavior at those top marginal rates and that's what's ... to make this plan as pro-growth as it could be, we really should have attempted to address that top rate-

Bill Walton: I don't know the tax history all that well, but wasn't part of the '86 tax bill where they dropped the highest marginal rate from something like 70 percent to 30 percent? Am I getting my tax history correct?

Rachel Greszler: Was it 30 or was it even lower? [crosstalk 10:59]

Bill Walton: What happened was, at that lower rate they collected three or four times the tax revenue from the higher earners. The history shows if you drop the rate, you collect more revenue.

Adam Michel: A similar story happened in the 1920s, similar thing in the 1960s and then the '80s, these big individual rate cuts were part of tax reform. This time around, the focus was always on bringing down the corporate rate because that was the most detrimental part of the tax system and we're moving that direction, and that's fantastic. It has left behind this other piece that is also important.

Bill Walton: For those of us who thinks the individual side is pretty small ball and doesn't get at ... Trump wants to call this cut, cut, cut, but it's more like cut. We've got one thing that's really cut here, which is on the corporate side and the individual side we can get into the details but it doesn't seem like it accomplishes an enormous amount. On the corporate side, though, we're going from 35 to 20 percent, which is good; puts us more in line with the rest of the world.

My goal was to get us to Ireland, which is 12 percent, but we didn't get there. We also expense capital expenditures immediately for some classes of assets and that's a good thing, that'll speed up capital investment. We also repatriate income from abroad, it was going to be a five percent tax rate and I think now, they've increased that today, as we speak, to a higher number.

Adam Michel: Yeah, to 14 and seven for cash and physical assets, but all of these things are moving targets at this point. We haven't seen the Senate tax and these things will keep moving.

Bill Walton: I'm sure the Senate will be very constructive. Why couldn't we have just done the corporate now and save the individual for later? Why do we have to do it all at once?

Adam Michel: We've tried to do corporate-only reform in the past. This was something that the Obama Administration was favorable towards. What makes it difficult is our system is, I think, it's 90 percent of businesses in America aren't those Big C corporations. Although that's the rate that really matters, that's the rate that is most detrimental currently. If you just do corporate-only, there's a big portion of the business community that feels left out.

Bill Walton: Which are individuals.

Adam Michel: Which are individuals and pass-throughs.

Bill Walton: Let's explain what these are. For the big companies, they're in the C chapter of the corporate code and for all of the other businesses that are LLCs, partnerships and S-CORPS, they don't pay taxes at the business level, they pay taxes ...

Adam Michel: As individuals.

Bill Walton: As individuals, as the owners. Those are taxed at the now 39 percent rate, so that's not enormously different from the 35 percent rate.

Adam Michel: Plus the 3.8 percent Obamacare tax.

Bill Walton: Plus the 4-point ... yeah. Okay.

Rachel Greszler: Plus some phase-outs.

Adam Michel: The AMT, please limitation.

Bill Walton: If you drop the 35 percent corporate rate to 20, then there's an enormous gap between the two. That's why it's got to be addressed. That's why you couldn't do it just the corporate.

Rachel Greszler: Yeah, I think also you talked about the class warfare before and when you do something that's only on the corporate side, no matter how many economists agree that the corporate tax is the most detrimental, you are always going to have people saying, "You just want to give big businesses back money." I think that's why we're bringing in the individual side and it's so much more popular when you're saying, "Oh, this is a middle-class tax cut."

Then I think they can swallow the business side and say on net this is a tax cut for the business community, for corporations, S-CORPS, whatever you are, but they also had to tie into it the individual so that they're getting something out of this tax reform bill because I think a lot of people focused more on what am I going to get back next year in my tax bill as opposed to how much higher is my income going to be in the long-term because you've done this economically advantageous corporate side reform?

Bill Walton: You mentioned most economists, I think corporate tax has been said to be a real damaging impact on both workers, consumers, capital investment. Some people argue that the corporate tax, if it went away, we'd see a dramatic wage increase.

Adam Michel: It's really difficult to sell that piece of it to people. The corporate tax brings in around nine percent of all federal revenue, but it's a double tax on the same income. Although those pass-throughs that you were just talking about are paying that 39 percent rate, the corporate side is paying a 35 percent rate and then again a 20 percent tax on the individual side when that profit is distributed through capital gains or dividends.

There's a compounding double tax on the corporate side that makes it even more destructive and you're right, those pieces paired together and our corporate tax rate being the highest in the world means that businesses have been leaving the United States. Not just their headquarters leaving; Burger King has moved to Canada, Anheuser-Busch has moved to Belgium-

Bill Walton: Would people call inversions?

Adam Michel: That's the sexy headlines, but what's going on underneath is they're actually moving physical capital abroad or not investing physical capital here and that is one of the reasons why wages haven't grown as fast as they should have. The most striking piece is, I think, over the last eight years or so, there's been a couple years where we've actually had negative capital growth per worker, which is horrible for wage growth for people getting additional skills and working with better technology, which is the key piece of increasing output and economic growth.

Reforming our business tax environment can allow businesses to invest in America again, invest in American workers again and that's how this translates to a larger economy, to higher wages, and that knock-on effect is hard to sell to people.

Bill Walton: The formula, though, is you lower taxes, businesses have more capital to invest, they could put it in plant equipment, things like that. That's better for productivity, better for wages and better for job growth.

Adam Michel: Exactly.

Bill Walton: We also have something in the bill that tries to attract the capital that's been kept outside the United States. There's something like two or three trillion dollars that people estimate is outside the United States, not being brought back by companies because they don't want to pay the higher rates in the US. What happens with this bill with that?

Adam Michel: We currently have a worldwide tax system where the United States attempts to tax foreign profits that are made in other countries by US-headquartered firms and basically no other developed country has this system and it effectively locks corporate profits that are earned elsewhere out of the United States, so if I earn some profits in Ireland or in Canada, the United States levies a tax penalty if I ever want to bring that money back and reinvest in the United States.

It has locked these several trillion dollars abroad. The system that's being proposed right now is called a territorial system and going forward it will not attempt to tax profits earned overseas, which levels the playing field for American businesses competing abroad. There's a transition measure for that trillions of dollars that are held overseas. They levee a one time tax and deem that money has been repatriated-

Bill Walton: To bring it back?

Adam Michel: Freeing it up so that it's no longer locked overseas.

Bill Walton: What's that number, what's that percentage?

Adam Michel: Right now, as of today, the numbers are 14 and seven, so 14 percent tax on liquid assets, so cash and a seven percent tax on money that's actually being reinvested abroad so that it's maybe being turned into a building or put into a factory. That's subject to change, I'm sure.

Bill Walton: Even though it's over there physically, it's deemed to be repatriated and you pay seven percent to get a good housekeeping seal of approval, that this is now in the territorial regime, not the worldwide regime.

Adam Michel: Exactly. It's not ideal policy. In a perfect world, that money shouldn't have been taxed in the first place, but as a transition tax to get us to a better world, we can live with some rate ... they're pushing it up higher than it should be.

Bill Walton: How did we get into a worldwide tax system to begin ... virtually every other country in the world is a territorial system. How did we end up with worldwide? Was it just because we were America and we thought we could get away with it? Do you know the history there?

Adam Michel: Almost every other country used to have a worldwide system, just like most other countries used to have a corporate tax rate that was in the 40, 35 percent rate like ours. As the world has become more global, every other country has realized that the corporate tax is an outdated tax that isn't properly tailored for global economies.

Bill Walton: Okay.

Adam Michel: As capital has become more mobile, as business supply chains have moved around the world, the corporate tax has become more and more inefficient and a worldwide system becomes more and more detrimental to the economy. As we've seen over time, almost every other developed country has moved away from a worldwide system and has systematically lowered their corporate tax rates and the United States, having not reformed our tax code since the '80s, we just have been left behind.

Bill Walton: I wonder whether or not selling the bill based on that. We're really laggards in the world taxation system, particularly when you think how ... the EU is so aggressive about taxing and things like that but they're way ahead of us here in terms of taxing capital creators and innovators.

Rachel Greszler: All the other countries are far more competitive and we just haven't jumped on that bandwagon yet. I don't know if it's because people don't understand the international taxation, you start talking about a territorial system and worldwide and that doesn't resonate with the average American and it's, "Oh, you're going to cut taxes for corporations by a significant amount." That's what it comes down to.

Bill Walton: I had to do a little reading to know what that was before the show. Most people don't know-

Rachel Greszler: Yes, exactly. You try to put either of those words, territorial or worldwide, into your headline phrase of why we need tax reform.

Bill Walton: We want to stop inversions ... it gets pretty-

Adam Michel: When you describe the problem of capitals moving abroad or businesses are inverting, most peoples' reaction is, "Well, why don't we stop them? We need to put regulations in place"-

Bill Walton: That's what Jack Loo did-

Adam Michel: Yeah, exactly, or we need to put a tax on businesses that try to move abroad to keep them here. That's the opposite of the way we should be looking at the problem, the way that most other countries have approached this is becoming more competitive. How do we attract businesses here? It's not just about keeping businesses from leaving, but there's a whole world of businesses out there that could be doing business here, employing Americans and that's really what this tax reform is about, is employing more Americans.

Bill Walton: With a territorial system with a 20 percent rate and being able to expense capital expenditures in year one and ... the computer's a great example. You buy a computer, there's a depreciation of three year or five year and within six months you've got to buy another one because it's out of date, yet you can't just write it off.

Adam Michel: You're still writing it off.

Bill Walton: Makes my accountant happy, he's got lots of schedules that he gets to bill me for. This is pretty dramatic in terms of growth on the corporate side.

Rachel Greszler: Yes, on the expensing note, this is an immediate expensing for most things but it's five years. It's temporary and that's due to revenue provisions and wanting to keep the bill within the limits and that time frame. What depends, going forward, is this going to have the full economic growth, the full expensing permanently would have, do the businesses really believe that it will be extended.

Bill Walton: Explain why that's a problem.

Rachel Greszler: If you're a business and you, under the current code, at the end of five years, the equipment that you invest is no longer going to be able to be written off, then after five years you stop investing. In the first five years, you get a huge boost in capital and productivity is increasing but then you get to that sixth year and now you're going to actually have a dirth investment because everybody's already made their purchases and then you start going down.

Bill Walton: We've got a five-year window, businesses will invest a little bit in year one, year two, but by year three, they're saying, "Look, this thing's going to run out, I'm going to go pile up equipment in the warehouse," so to speak and then, year six, nobody's buying anything.

Rachel Greszler: Exactly.

Adam Michel: The provision that's in there only applies to new equipment, which is significantly narrower than it otherwise could be. The full expensing should not only be permanent but should apply to all business expenditures.

Bill Walton: Sure.

Adam Michel: Not just new equipment, so it currently exempts structures, it exempts used equipment and that also leaves a lot of growth on the table. Although, yes, this is a step in the right direction, I think the tax foundation estimated that this current plan would grow the economy by about 3.6 percent over ten years, it'll be 3.6 percent larger than it otherwise would be at the end of ten years.

That's about half the growth that we could've seen from a more robust, business side reform of full expensing-

Bill Walton: 3.6 annual or 3.6 over ten years?

Rachel Greszler: At the end of the ten year.

Bill Walton: What does that work out per year, like 0.1 percent?

Rachel Greszler: You grow over time, although that expensing makes it level off-

Adam Michel: I don't know what it turns into year over year, but it's less than the one percent increase that, say, the president has touted.

Bill Walton: The funny thing that got us into both the individual and the corporate at the same time is this pass-through. Let's dig into that a bit, I want to get to the individuals in a minute. I think there are 27 million businesses that are taxed as pass-throughs, or what nine million businesses taxed as pass-throughs and 27 million sole proprietorships. There's some big number, 30, 40 million businesses would be affected by this kind of change.

Adam Michel: A majority of the businesses in the United States are these pass-throughs that file as individuals and what they're doing is really complicated. The bill cap puts a ceiling on the tax rate that pass-throughs pay of 25 percent, but then anything above that, they added on some additional complicated rules that are really there because they haven't lowered the top wage rate, that 39 percent rate that we talked about.

In the current universe that we live in, those rates are the same and there's not a problem of businesses re-characterizing income into business income to game the system. Because they've split these rates, they're now having to write complicated rules to prohibit gaming of the system, essentially, so we're in this second-best world that requires these rules. They have a 70/30 rule on ...

Bill Walton: Taxpayers can elect to use alternative facts and circumstances. In general, 70 percent is treated as salary, 30 percent is pass-through capital income. There's going to be a test, looking ... an investment in the company, multiplying that by the sum of the federal short-term rate plus seven percent.

Adam Michel: Sounds like simplification to me.

Bill Walton: Sounds like a mess to me. Then, listen to the industries that are excluded. They're excluding health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics. Athletics, those are ball players. The financial service golfers, golfers can't be pass-throughs. Brokerage services ... trader business, where the principal access of such trader business is the reputation or skill of one or more of its employees.

This is open field for litigation and tax lawyers. They couldn't do better than this after thinking about this for years?

Adam Michel: This is a product of not wanting to lower those top-

Bill Walton: The top individual rate.

Adam Michel: All of these things fit together and put us into a place that is not ideal. They're trying to not lower taxes on the rich but provide a tax cut to small businesses and often these things are incompatible. You can't design a system that does all these things at once without these complicated rules.

Bill Walton: To solve this mess, they could've just dropped the top rate and gone with the theory that history's maybe a predictor of the future and in the past when we dropped these rates, we increased revenue. That would've gotten the pay floor stuff done. Is that correct? If you believe that.

Adam Michel: Yes.

Rachel Greszler: That brings up the scores, which is just this box that Congress is in. You have the distributional scores-

Bill Walton: Let's talk about scores now, this is a good segue to scores.

Rachel Greszler: Yeah. You don't get those revenue effects. We don't really have dynamic scoring. We might get some dynamic score called dynamic score coming out of the joint tax committee. They're not going to give the full true growth effects that we believe are going to happen. You're tied into ... the Senate passed this 1.5 trillion dollar maximum tax cut, that's all they can do. Now you're just trying to get the revenue necessary.

Bill Walton: To clarify, dynamic assumes that people respond to incentives and to rates and if they're paying a 50 percent rate will behave one way, if they get a 25 percent rate they'll behave another way because they'll use that capital to do something. That capital might go into innovation, investment and growth so you'd see more economic growth. Static scoring is what we're using primarily, which says you can cut a tax and it has no effect at all.

Rachel Greszler: Exactly.

Adam Michel: You can raise a tax and it has no effect other than bringing in more and more revenue, which is not always the case.

Rachel Greszler: 70 percent tax will bring in twice as much as a 35 is what the static score will tell you. We all know that's not true because people aren't going to save as much, invest in much, et cetera, at a 70 percent rate as they will at a 35.

Bill Walton: How can we cut this Gordian knot? Do we need some bold Speaker of the House to do it?

Adam Michel: A couple other things that we pushed for and had hoped to see in these reforms is changing some of the budget rules that constrain the process. Currently, they budget on a ten-year window and then they're lowering that revenue estimate to 1.5 trillion. One of the things that we had hoped for is to see a longer 20-year window and allowing a lower revenue target beyond that 1.5 trillion to give Congress room to actually provide a tax cut to everyone, not have to get all these complicated rules to make that 1.5 number work.

The economic growth would make it not nearly as deficit-heavy as it otherwise would be. It's working in the system, saying, "If JCT is going to give us this irresponsible score, we'll work within that world but, in reality, we understand that this isn't actually going to be a tax cut of three or four trillion dollars." In the real world, economic growth is going to make up a big piece of this.

Bill Walton: Yeah.

Adam Michel: That's not what we're seeing right now and that's what's put us in the place that we see Congress making these horrible trade-offs to hit their revenue target.

Bill Walton: Got it. We repeal the state tax in this bill.

Adam Michel: In year six.

Bill Walton: We wait until 2023, so this is going to be ... you can put a lot of investment dollars in the life support business.

Rachel Greszler: Yeah, you do double the exemption immediately.

Bill Walton: Keep that alive for another year.

Rachel Greszler: For some people, if they're not that close to death, then it's not a big deal but, yeah, this five-year window we have going on.

Bill Walton: What are they thinking? Why not just do it? The state tax collects is ... it's one percent or less of the total tax-

Adam Michel: 0.7, yeah.

Bill Walton: 0.7. It's purely a political knot again to going after the wealthy.

Adam Michel: This revenue piece. Every dollar they're adding up in this process to get to that 1.5, so the delay allows them to have a little more expensing and have a slightly lower corporate tax rate. Each of these things that you turn the knob on a little bit, something else has to give.

Bill Walton: This is more like Whack-A-Mole.

Adam Michel: Yeah, exactly.

Rachel Greszler: 1.5 trillion over ten years is really not that big at all, so we started with not that much to play with and I think that's why we're seeing a lot of the policies that normally would not be even talked about in a program of tax reform. It would be given ... of course we're going to eliminate the estate tax, of course we're going to reduce the top marginal rate but you've really gotten down to playing with single-digit billions of dollars per year.

That's why I think we have these things you're talking about. Phasing certain rates in, phasing other things out. It's just come down so much on the revenue side.

Bill Walton: Well, let's talk about the politics briefly. Because last time I checked, and I don't think this will be true for a very long time. The Republicans control the House and the Republicans control the Senate. The Republicans are for dynamic scoring, is that universally true? Is that fairly-

Rachel Greszler: Yes.

Bill Walton: Okay. Democrats don't. If you control the House and the Senate, why can't you just say, "We're not going to play this game, we're going to play by a different set of rules, we're going to play by dynamic and we believe that this bill does what it ... if we want a growth bill, we expect growth to come out of it and let's eat our own cooking."

Rachel Greszler: You are somewhat limited, though. You can't change those things necessarily within the time window that we have here for tax reform, so you're relying-

Bill Walton: Is it statutory?

Rachel Greszler: Yeah, the Senate has some control over which score they're going to choose to use, but it's not like they can call up the tax foundation and say, "Theirs is the most favorable score, we're going to pick that and use it." They're limited in that.

Bill Walton: Well, they do that with polls.

Rachel Greszler: Polls, but not when it comes to the legislative side.

Bill Walton: Yeah.

Adam Michel: A lot of it is a lack of desire to make that bold move to say we no longer want to be constrained by these arcane rules. It's really they're allowing themselves to be shackled by process. You can debate whether or not that process came from a good place or has a role in the future, but a lot of the things they can change. It's just a matter of mustering the political will to change them.

The majority in the Senate is pretty slim. If you don't have everyone 100 percent on board, a lot of these things just become more difficult than we would like them to be.

Bill Walton: You all wrote an excellent analysis of this last week. The GOP tax plan would revitalize the US economy, which I highly recommend. It's on the Daily Signal website, it gets into the inside baseball of this and the sausage making, but one of the things that I found concerning is the headline is there's tax relief and yet you look at what's happening with rates. There's the so-called bubble tax, there's the extra tax for people who make between 200 and 400,000.

What is all of this telling me?

Adam Michel: I see you have little smiley faces and frowny faces-

Bill Walton: This is a courtroom and I'm handing the documents to the defendants. I've got very few smiley faces and lots of frowny faces. You want to tackle that? Just explain a couple of those bullet points to me.

Rachel Greszler: Yes, so as we talked about in the beginning, this is a rate cut and it's also in that tax bill cut. At the end of the day, how much do you pay the federal government for lower and middle income families? Once you shift up that income scale, the way that they've changed the brackets is such that a lot of income is now subject to a higher tax rate. What might've been 28 or 33 percent before is now going to be 35 percent.

They've moved up the 39.6 percent rate particularly for married couples, they did get rid of the marriage penalty that exists there. On net, this group of people is generally not subject to any lower marginal rate and for the most part they're paying higher tax rates in that window between about 200 to 750, say. You're also getting rid of a lot of the exemptions, deductions that these people used to take.

For the most part, this is a general tax increase there, except for those that have the pass-through income. Then we'll get onto the bubble rate. Currently, the 39.6 percent rate is the top headline rate. We were hoping it would've been 35, they kept the current rate so no tax cut, but actually tax increase. If you are a single individual, once you start making a million dollars and if you're a married couple, once you start making 1.2 million, they're going to recapture the benefit of having earned 45 or 90,000 dollars at a 12 percent rate.

They're effectively saying we're taking this back from you. That's like scaling back 12,000 dollars from individuals, 25,000 dollars from married couples. How they do that is they put on a bubble rate and they add six percentage points, so you're at 45.6 percent now until you've recaptured that whole benefit of having the lower rate. You have 39.6, 45.6 and then you go back down, 39.6. It's not simplifying for this top rate.

Bill Walton: The highest earners aren't going to be paying the highest rate.

Rachel Greszler: Yes, I'm glad you brought that up because-

Bill Walton: People stuck in the middle that are going to be paying more than the highest earners.

Rachel Greszler: This happened in 1986. They needed some more revenue, and so they did the exact same thing and created a 33 percent bracket and then, going forward, it was pointed out, well, this isn't fair. You have people making five million and they're not paying the top marginal tax rate, and so the solution should've been, "Okay, let's get rid of the bubble rate." Well, no, they raised the top rate to 33 percent.

Do we want to have a 45.6 percent rate going forward now?

Bill Walton: Oh my. Well, also in this bill ... state and local deductions partially eliminated.

Rachel Greszler: Yes. I've done a lot on the state and local side and analyzing the IRS data and who does this benefit. It's a horrible policy to begin with. What are you doing by letting people deduct the taxes that they pay to their state and local governments, you're encouraging the state and local governments to raise taxes higher than they otherwise would. California has a top marginal tax rate of 13.3 percent, but once you deduct that from your federal taxes, you're really only paying eight percent.

Who's paying that other 5.5 percent is every other American in the other 49 states. It's a bad policy. Eliminating it is a great thing, but in the House side, you have some conservative members from New York and New Jersey in particular who said, "We can't afford to get rid of this deduction. It hurts our constituents too much."

Bill Walton: Politics are interesting here. It's California, New York, New Jersey, Illinois, Massachusetts, Maryland and Connecticut, and the last time I checked there were no Republican senators from any of those states.

Rachel Greszler: That's where it gets interesting. On the House side they had to compromise and they said, "We're going to keep a property tax deduction up to a cap of 10,000 dollars per year." On the Senate side you don't have any conservatives from those states, so it's possible that maybe that's some new revenue that they can get in, is by fully eliminating the state and local tax deduction and not keeping that property tax deduction that they have so far.

Adam Michel: Then, when it goes back to the House, it'll be a game of political chicken, theoretically. If the full salt deduction is eliminated, the state and local tax deduction-

Bill Walton: State and local tax, okay.

Adam Michel: Yes. Then those representatives that are from those high tax states will have to make a decision: do they vote for comprehensive tax reform or do they not? It'll hinge on this issue of the deduction that ... I can't think of any Republican that would vote against this sort of tax reform that we're talking about on the basis of this piece, but-

Rachel Greszler: Some of them did get out there and say, "I will not vote for a bill that eliminates all the state and local taxes."

Adam Michel: Some Republicans are holding this tax reform hostage because they don't want the subsidy for expanding bureaucracies in New York, New Jersey and California to go away, which, on its face, is pretty perverse.

Bill Walton: We've got a couple minutes left. Where do you think this is going to end up?

Adam Michel: We have a House bill, it's being marked up or it's being finished marked up right now. We should get a Senate bill next, which will be slightly different than the House bill but not dramatically. The same process will happen in the Senate. They'll make some changes and then the two bills will come together. I think from what we know thus far, we'll see big change in the corporate tax rate down to 20 percent.

We'll see some expensing, these are all the pro-growth things that are really good. We'll see some increase in the child tax credit, we'll see a doubling of the standard deduction, we will see rates come down for most people. Hopefully, we'll see a little more relief for small businesses and then the question is how does it get paid for? Eliminating the state and local tax deduction, the repatriation tax we talked about, eliminating as many carve-outs and special privileges that are in the tax code.

That's how we fund a lot of this. I think those broad contours will be there when it gets, hopefully, through the House and the Senate. It's just a matter of what trade-offs they end up having to make along the way.

Rachel Greszler: They might have a little extra money to play with in there if we have the dynamic score from JCT by then, which should be hundreds of billions, maybe two to four. We don't really know for sure, but there will be some money. That's something that may provide something ... the Senate side, certain members over there would like to see a higher child tax credit, even higher than the 1,600.

There's some other provisions that would be in play but I think we could also expect more complication. I don't think that the bill will get simpler moving forward. Timeline, I think they're aiming for Thanksgiving to have a final package between the two and certainly passage by the end of the year.

Bill Walton: It doesn't really simplify, doesn't really cut the top rate but it does a lot on the corporate side to promote growth. It's not perfect but it's better than nothing.

Adam Michel: Yeah. I'm more optimistic than that because this is just the first iteration of it, but we'll still see changes being made going forward. I think if we keep up pressure on needing to see a lower top marginal rate, that paired with a little more relief for those pass-through businesses and then we have the expensing piece, at least temporarily. We have the lower corporate tax rate.

This is setting us up to get a good piece of tax reform. It's about keeping up the political momentum to really drive home these things that are necessary pieces of a pro-growth tax reform.

Bill Walton: Well, thanks guys. Rachel, Adam, I'll look forward to talking with you more as this progresses and hopefully we'll have another bite at the apple, maybe another tax bill next year. We can do some good then. Anyway, thanks and we'll see you soon and good show.

Rachel Greszler: Thank you.

Bill Walton: Thanks.

Adam Michel: Thanks for having us on.