



## Interview With Ernest S. Christian

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**INTRODUCTION:** Ernest Christian is the Executive Director of the Center for Strategic Tax Reform and has influenced the formation of tax policy for over 30 years. He served as Deputy Assistant Secretary for Tax Policy in the Ford Administration, was a member of President Reagan's tax transition team in 1980-81, and was the leading drafter of the USA Tax proposed by Senators Nunn and Domenici in 1995.

### **Q: What is the Center For Strategic Tax Reform, and what does it do?**

A: CSTR is a non-profit organization set up about fifteen years ago mostly to hold seminars about tax reform. I founded it in partnership with Murray Weidenbaum, who chaired the Council of Economic Advisors in the Reagan Administration.

We have been holding seminars about once a month for the last fifteen years. Most of the major players in tax reform, people from think tanks, corporations, government and Treasury, attend regularly. We use a round-table format and we have speakers. Mostly, it is a forum for experts and nonexperts interested in tax reform and social security reform.

We've also started a website and we've published numerous papers. Our website includes a treasure trove of valuable analytical materials on tax reform.

**Q: Over 20 years ago, you advocated a business transfer tax that was a subtraction method VAT, with credit for part of the FICA tax. You saw this approach as promoting exports. Today, your proposal seems prescient in combining those three features, all of which are current hot topics. In 1989, you and others also wrote a book on the VAT. How did you come to these views so early?**

A: At the Treasury Department in 1970 and 1971, I started looking at value added taxes in the context of the income tax and a cash flow tax. A VAT is really not all that different, contrary to what a lot of people imagine.

I think that anyone who really thinks through and compares the basic economics of a VAT and what we call an "income tax" will come to the conclusion that they are very similar. The main differences are that a tax on business value added is a tax on all of the factors of production: the output of labor and the output of both debt and equity capital. The corporate income tax, on the other hand, is a tax on the output of equity capital. But the same

corporations that pay income tax also pay an employer payroll tax. If you combine the payroll tax on the output of labor with the corporate income tax on the output of capital and coordinate them appropriately, you've essentially got what people like to call a subtractive VAT.

That is the background, and I think that anyone who looks carefully at this question is likely to come to much the same conclusions. It just happened that I got started looking at these things and talking and writing about them somewhat earlier than many of my contemporaries. Most people today are coming to the same kinds of conclusions that I've been talking about for a long time.

For reasons that seem to be based more on their own agenda than on analytics, there are people who still like to think of a value added tax as a kind of multi-stage sales tax. Those people perpetuate propaganda that the Europeans have been feeding us for many years. Pardon me for saying so, but I think the Tax Section of the American Bar Association was one of the groups that bought off too early on the idea that a value added tax is a type of sales tax that is perforce borne by consumers.

I wonder how people came to believe that a value added tax is a "consumption tax" that automatically increases retail prices. The corporate income tax and the employer payroll tax combined have essentially the same base as a VAT, but no one thinks of them as taxes on consumers.

**Q: You later disagreed with proposals to impose a VAT as it is normally adopted. Did you change your views and, if so, why?**

A: It was during the 1980s that I began to dissent, not from the kind of tax I had pioneered but from the false characteristics some people attributed to it. Proposals started to appear for "business transfer" and other cash flow taxes that some people called "subtractive" value added taxes. After I drafted the original ones in the 1980s, other people tried to attribute to them characteristics that they didn't actually have. Some people looked to the Europeans' self-serving explanation of their VAT. Following that false trail, they concluded that any tax with a base equal to value added and which has border adjustments for imports and exports must increase domestic prices, reduce export prices and increase import prices -- all in accordance with the "origin and destination" principle that pervaded the literature at the time. At the same time, a group of economists suggested that the trade effects of the lower-priced exports and higher-priced imports would be offset by "instantly adjusting exchange rates." All this was, of course, nonsense for the simple reason that the value-added-based cash flow taxes did not have much across-the-board effect on prices to start with.

An export exclusion for American-made goods sold into the international market is a good idea that is intended to alleviate to some extent a large disadvantage that American companies currently suffer. We are the largest economy in the world's marketplace, but we are the only economy that does not have a border adjustment for exports. Now, if you sit down and work your way through it with a pencil, you'll see that by being the odd man out and the only one not participating in this game, American corporations are put at a

considerable disadvantage. That does not mean that adding a border adjustment for exports is suddenly going to have a dramatic impact on our trade deficit. It is not. But it will in the long run help exporters.

The important thing about an import tax (and the most interesting) is not that it is designed to keep goods out. It doesn't do that. It is not even particularly designed to make foreign-origin goods more expensive. It would in the case of some unique commodities, such as oil, bauxite, and other kinds of things where the world price is the price and we have to pay it plus tax, no matter what -- but most of those products would be excluded from the import tax anyway.

Most of the vast array of imported goods are competitive goods and if there is a tax at the border on such goods coming into the United States, most of that tax burden would not be borne by Americans in the form of higher price. It would be borne by foreign producers and sellers, who would basically eat most of the tax in order to maintain market share.

**Q: You were said to be instrumental in the enactment of ACRS, the depreciation method that was said to approximate expensing, if not better, when combined with investment credits. How did your experience with ACRS influence your views on tax and capital formation today?**

A: Expensing is the correct result. It has always been the correct result, and of course, properly understood, the tax on business value added allows expensing. ACRS was an interesting exercise, and at the time it was pushing the envelope about as far as it could be pushed. We thought that we had accomplished a great deal.

When President Reagan came into office, there were two things that were pretty much set to be done: the marginal rate cuts and ACRS. We knew that the combination of ACRS and the investment credit could produce a result that in certain circumstances was approximately the same as expensing. For those of us who thought expensing was the correct answer, that was fine. Interestingly, during the course of the 1981 Tax Act, Chairman Rostenkowski of the Ways and Means Committee saw that ACRS plus the investment credit was going to be passed and offered full expensing instead. That offer should have been accepted. Subsequently, of course, ACRS was pared back, and we ended up losing the investment credit in 1986.

**Q: You have been active in the tax lobbying process for over thirty years, both as a listener in the Treasury and as a speaker for private clients. You are now with an organization. How has the process changed over that period?**

A: Thirty years ago, most law firms in Washington considered lobbying to be beneath them. Many of them did it, but they did not like to admit to it. Gradually, however, the process changed so that law firms began to practice in all three of the forums that were available for solving their clients' problems: the administrative forum, the courthouse and, here in Washington, the Congress. That approach has now become standard.

Thirty years ago, there were very few people doing tax lobbying in Washington. Those who did it were part of a pretty small club. Certain people around town were knowledgeable about tax policy, and people on the Hill and in the Treasury knew that, and tax policy matters were worked out among that fairly small group. Tax lobbying used to be a bit more cerebral than other kinds of lobbying. But today, it is hardly distinguishable from other kinds of lobbying.

The other big change has been the declining role of the Treasury Department. The Treasury Department no longer has the monopoly power of knowledge that it used to have. Today, there are people all over Washington, in think tanks, law firms, consulting firms and elsewhere, who are just as capable of dealing with the minutiae of the tax code, the economics of taxation, the politics of taxation, and the revenue estimates, as the Treasury Department. As the Treasury has lost its monopoly position, tax policy has tended to be made more in the White House, which has at its disposal many information sources other than in the Treasury Department.

**Q: In 1977 you wrote a study for the American Enterprise Institute on corporate tax integration. In 1990 you advocated corporate tax integration by reducing the corporate tax rate to 28% and eliminating taxation of dividends. Two years later the Treasury produced its integration study. In view of the recent reduction of tax on dividends, do you see integration as inevitable, stalled, or progressing slowly?**

A: I think the substance is about to happen because it is a big part of tax reform. The older ideas, such as "gross-up and credit", that many of us spent many fascinating and laborious hours of working on (as did the Tax Section of the American Bar Association, the ALI and others in the early days) are being superseded by the truth. The modern way of looking at a two-tier system is to see the tax at the business level as a pre-collection device of a fairly low-rate tax that is uniform across all kinds of income -- income from debt capital, income from equity capital and income from labor.

The likely shape of the tax code in the future is exemplified by David Bradford's X Tax, which is really the fountainhead of most thinking today. Variations of it, such as the Simplified USA Tax and most other options that tax reformers are talking about today and that are being put before the President's Tax Reform Advisory Panel, are essentially integrated systems.

**Q: Five Easy Pieces was a 1970 film with Jack Nicholson. In 2002 Jack Kemp publicized your tax proposal of this name, which included (1) low marginal rates across the board; (2) full first-year expensing; (3) elimination of the double tax on personal savings (i.e., do not tax both the amount saved and the earnings on savings); (4) elimination of the double tax on exports; and (5) exclusion of foreign-source income. Although the publicizing of this plan by name only dates to 2002, it appears to be a blueprint for White House policy since 2001, if not prior Republican strategy. When did you devise it and how?**

A: Many years ago, after talking with David Bradford and studying his X Tax ideas, I became convinced that when reduced to their economic substance, all of the much ballyhooed "brand name" tax reform proposals (including my own) could be accomplished by five familiar

amendments to the existing code.

As for my plan being a blueprint for anybody's tax policy, I don't really know. I doubt it. The President himself is one of the main tax reformers around. Five Easy Pieces was just rather a catchy name that my friend Jack Kemp and some others put on ideas that were put forward by all of us old-line tax reformers, going back to David Bradford, Norman Ture and other real experts.

Norman Ture was the Undersecretary of the Treasury under President Reagan, a noted public finance economist and friend, David Bradford, was at the Treasury Department when Bill Simon was Secretary, and I was there a part of that time in the 1970s. Along with Bill Andrews at Harvard and a few others, they were really the intellectual fathers of the correct way of thinking about tax reform -- look at the economic substance and do not be misled by academic argot about "consumption taxes", "VATs" and fictional distinctions between "direct" and "indirect" taxes.

I gradually came to the conclusion around 2000 that everyone, including me, had really missed the boat. We really should be taking a minimalist approach to tax reform. Reduce it to its absolute key components. It became obvious to me in looking at "big bang" tax reform proposals that I could get the same economic results simply by taking the current code and allowing expensing, removing the double tax on personal savings, doing something about the treatment of dividends and gains, excluding exports from double taxation, and then adopting a territorial system instead of the silly kind of worldwide system that we have now.

The problem with the tax code is that it is a terrible drag on economic growth. It costs the American people hundreds of billions of dollars of lost income every year. That adds up. GDP is smaller today by a huge amount compared to what it would be if we had had the correct kind of tax system thirty years ago.

When you get to tax simplification, you do not have to repeal all deductions and credits in order to simplify the tax code. The big problem with deductions and credits is not that they exist, or that they exist in such quantity. The big problem is that most have "eligibility" rules. There are too many income phase-outs and phase-ins. There is PEP and there is Pease and all the other absurdities, so that people don't know which deductions and credits apply to them and which do not -- and under what circumstances and when.

The Simplified USA Tax that some of us created to get rid of the tax code's bad economics and pointless complexity keeps most of the basic deductions that are traditional in America. We then rewrote in plain English the parts of the tax code that we were going to keep, at least the relevant parts of Subtitle A. The result that emerged was a very slim volume that is readily understandable.

The bottom line is that there is an answer to tax reform, but it is not the one that most people like to amuse themselves with or that the academics like to talk about. The real answer may not be very exciting but it will be effective in both economic and simplification terms.

**Q: Do you think fundamental tax reform will occur during this presidency, and if not, what combination of political events could come together to make it happen in the next presidency?**

A: I think it is going to happen in this presidency. I actually think it is going to happen in this Congress. It is popular among the experts to say "Oh, it will never happen; it is politically impossible." And of course, they could be right, but people in Washington are often too pessimistic. Partly they like to play it safe, and partly they look at tax reform through far too narrow a prism.

Let's start with businesses. Businesses (and of course their hired guns in Washington) mostly think about taxes in terms of how much out of their profits they have to pay in taxes. But the way businesses ought to think about tax reform is to ask, "What is the tax system doing to the size of our profits?" They should say, "Our profits would be bigger if we had a tax system that did not impede economic growth so much. It would allow GDP to be bigger. Our profits would be bigger."

Individuals need to think about taxes in the same way, even people who do not pay income tax. We have taken so many people off the tax rolls that an awful lot of voters really do not pay income tax. But even those people need to recognize that the tax system's impact on the economy is enormous, and, therefore, its impact on them is enormous. What is done here in Washington in terms of changing the tax system has a big effect on the size of their incomes, whether they pay taxes or not, because it has a big affect on GDP.

I believe that Congress is going to do tax reform reasonably correctly in the near future, because of the philosophical and other changes occurring in America.

We have a younger generation of Americans who think more like capitalists, who aspire to be capitalists, who are born more affluent, who are accustomed to affluence and who want a "piece of the rock," as some television ads use to say a long time ago. When you get down to the nut of the matter, tax reform is about savings, investments, wealth creation, and more and more people having the opportunity to participate in the rewards of capitalism.

President Bush has already shown more leadership on tax reform than any other president and I believe that he will follow through on his pledge.

Another reason that tax reform is going to happen is because it has been sneaking up on us for a very long time. There is a lot more knowledge about it -- both in Congress and outside Congress. It is not necessary to reinvent the wheel. The alternatives and the likely options are pretty well known. You can call it something else, but the substance is essentially the Five Easy Pieces, because that is the way the tax system actually works. That is what the economics of the tax code is about.

Once members of Congress get over their fear of tax reform, and get over the idea that they are going to be forced to vote against home mortgage interest or something like that, they will want to do it. Tax reform done right can become good politics, and is becoming good politics.

For all those reasons, I think it is going to happen during this Congress, or, if not in this Congress, then certainly during this Administration. If it doesn't happen during this Administration, with all the factors that weigh favorably toward it, in my own view, it may never happen. It's either now or never, it seems to me.