MODELLING THE ECONOMIC OUTCOMES FROM TVM:
IS IT PRACTICAL AND MEANINGFUL?

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1 RBT AND INCOME

What is the preferred base of a tax on company income? The answer to this question has been the subject of considerable literature and much unresolved debate. At its most general, the debate has focused on two alternative bases: income and cashflow. Meade(1978)[1], in a major contribution to this debate, found strong support on economic efficiency grounds for a cash flow company tax. Despite a substantial literature and a spirited debate through the late 1970s and 1980s on the merits of a cashflow company tax, it has not been adopted by any government[2].

In fact, what this literature highlighted was the substantial failings of company income taxes due largely to their hybrid nature, being somewhere between a comprehensive income based tax and a cashflow tax. Much of the original support for moving in the direction of a cashflow base appears to stem from the observation that company taxes were becoming not dissimilar to cashflow taxes in terms of their ultimate tax base. Despite this apparent observation, no country appeared willing to make this move explicit. This is probably because the company income tax cannot be easily divorced from the personal income tax nor from the practices in other countries in relation to their taxation of capital.

Not surprisingly, what resulted during the late 1980s and 1990s was action focused on arresting the erosion of the company income tax base. The approach taken by the Review of Business Taxes (RBT) was in keeping with this move to redress the erosion of the company income tax base but was couched in a more pragmatic guise[3]:

> …as a fundamental principle for business tax arrangements, for various reasons:
>
> - income tax has been the relevant base historically;
> - the Government's reforms, announced in *A New Tax System*, are predicated on that base;
> - many practical design issues would need to be resolved before a tax base switch could be recommended, and the Review's timeframe is inconsistent with the magnitude of that task;
> - no major country has an expenditure-based tax system, although many, including Australia, have what can be characterised as elements of an expenditure tax base generally aimed at stimulating investment – the practical design issues just mentioned have impeded concerted implementation of such a tax; and
> - the Review's terms of reference — particularly their focus both on the scope for a lower corporate tax rate and on revenue-neutral reform of investments and CGT arrangements — require an income tax base.

This RBT approach has nothing to do with academic rigour and everything to do with a desire to avoid fundamental changes to the definition of the company tax base and how this tax interacts with the personal income tax and with the company tax regimes in other countries. As Prebble(2001) noted recently, no country in the world has undertaken a major shift in the base of its principal general revenue taxes.

In common with tax inquiries in other countries since the publication of the Meade Report in 1978, RBT sought to adopt a cashflow tax but to move the current hybrid company income tax towards a comprehensive income tax. The RBT faced one major obstacle - the Australian

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[1] See Chapter 12 in Meade(1978).

[2] See Kay and King(1980), Mieskowski(1983), Albon, Findlay and Jones(1983)

[3] RBT(1999a), p10-11.

company income tax has its foundations in trust law and judicial interpretation rather than in any economic principle[4]. What RBT therefore saw as lacking in company income tax law was a principle-based tax flexible enough to accommodate continually changing economic circumstances. Since the current company income tax lacked any underlying economic principle, this meant that company tax law had become increasingly complex as the statutes have had to be constantly amended to meet changing economic circumstances.

This lack of an underlying principle in the current Australian company tax system motivated the RBT to make explicit those principles already underpinning this tax. To achieve this end, the approach taken was not to seek further amendments and elaborations to current law but to move to an approach which had as its focus, a recognition of the substance of a business's transaction, rather than its form. This meant an approach which had strong economic foundations. It was here that the RBT found a strong case for its proposed net cash flow/tax value method[5] (TVM) of measuring company income. The purpose of this paper in not to question this proposal but rather, to attempt to assess the economic impact of such a tax and how this might support the case for such a tax reform.

To appreciate how TVM might impact on businesses and the broader economy, it is essential that the attributes of TVM be clearly appreciated. To this end, the first part of this paper will seek to outline exactly what TVM is and is not, and the remainder of the paper will go on to assess its potential economic impact.

2 RBT COMPANY INCOME TAX BASE IN PERSPECTIVE

The key consideration leading the RBT to recommend TVM is best understood by the following statement:

> "Defining income in a manner structurally consistent with both economic and accounting approaches to income measurement – rather than relying on the current mix of statutory and judicial definitions of assessable income offset by an unstructured and highly differentiated set of deductions – supplies the high level unifying principle that cannot be found anywhere in the current income tax legislation. Application of that unifying principle will provide structural integrity and durability to the income tax law that the existing patchwork definitions simply cannot offer, however they might be amended."
> (RBT, 1999, p157)

The net cash flow/tax value method of defining company income was preferred by the RBT because it was an economic principle-based framework which would 'achieve a more robust and durable tax system' (RBT, 1999, p155).

The RBT proposal has its foundations in the economic concept of income proposed by Simons(1938, p50-51) who defined income as all (and only) economic gains arising during a specific time interval. For an individual, this is defined as the sum of '(1) the market of rights exercised in consumption and (2) the change in the value of the store of property rights between to the beginning and end of the period in question'. Hicks(1939, p172) suggested that 'income is the maximum value which a man can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning'. Put more simply, for the individual,

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[4] Parsons(1986) and Prebble(2001).

[5] See <www.rbt.gov.au> and <www.treasury.gov.au>

comprehensive income is the sum of consumption during the period plus the changes in net wealth (which is the difference between 'net wealth' at the end of the period and 'net wealth' at the beginning).

For a company, comprehensive income (CI) can be defined as equivalent to:

$$CI = NCF + \Delta VNA \tag{1}$$

where

NCF = net cash flow

and

NCF = R - P = Receipts less Payments

ΔVNA = change in the Value of Net Assets

and

ΔVNA = ΔA - ΔL = Change in Assets less Change in Liabilities

It is important to note that Accounting Standards now define profit as the difference between revenue and expenses where revenue is equal to 'inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets … other than those relating to contributions by owners'[6] (or R+ΔA). Expenses are 'consumptions or losses of future economic benefits in the form of reductions in assets … other than those relating to distributions to owners'[7] (or P+ΔL).

The comparability of this accounting concept of profit (AP) to the comprehensive income concept is clear and hints that there are parallels between the economic concept of income and the accounting concept of profits. However, this accounting concept of profit is different from the Australian definition of taxable income (or profit) and has led to calls for the alignment of the tax and accounting concepts of profit.

The situation is even more complicated because taxable income (TI) under the Australian company income tax is simply:

$$TI = \text{Assessable Income} - \text{Deductions} \tag{2}$$

where

Assessable Income = Ordinary Income + Statutory Income

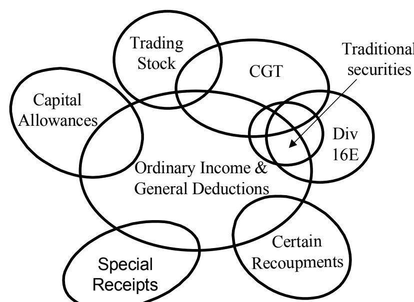
Deductions = General Deductions + Specific Deductions

This is best illustrated in Figure 1.

[6] Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements", paragraph 111.

[7] *Ibid,* paragraph 117.

Figure 1 Current Law



In practice, assessable income is not estimated directly but by making adjustments to accounting profit to take account of items that:

(i) should be and are not included;

(ii) those that are included and should be omitted; and

(iii) those that are included but with a different value.

In summary, CI ≈ AP ≠ TI.[8]

A key criteria underlying the RBT reform proposals is that any change to the current company income tax had to be revenue-neutral. As the TVM Explanatory Memorandum (EM, June 2001, para 2.33) notes, 'As a general statement, the Tax Value Method isn't intended to change tax outcomes; either the amount that is taxed or the time at which it is taxed.' This must means that their will be no (or at worst marginal) net difference between the outcome from the current company tax law and TVM law both in terms of its impact on companies and on aggregate tax revenue raised[9]. The key change with TVM is therefore how taxable income is defined in the tax legislation, not necessarily its impact on companies.

In recognising that the current company tax taxes TI in (2) with the complications arising from its operation as shown in Figure 1, RBT sought to redefine TI so as to accord with the conceptual framework used to estimate CI in (1). The problem is however that CI as the base of a company income tax is not operational either for tax collectors or tax administrators[10]. The RBT solution was to adapt CI in (1) so as to make it more operational. This is the primary rationale for adopting the Net Cash Flow/Tax Value Method (TVM). Under TVM, at its most simple, net cash income (NI) for a company is defined as:

$$NI = NCF + \Delta TVNA \qquad (3)$$

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[8] Put in words, CI approximates AP but is not equal to TI.

[9] Clearly, even marginal definition changes are likely to impact on some companies more than others and so we would expect there to be some differential impact on different companies. This issue will be elaborated on later in the paper.

[10] See RBT(1999a, p29) for a discussion of the issues.

where

NCF = net cash flow

ΔTVNA = change in the tax value of net assets.

NI can be disaggregated into its constituent parts so that:

$$NI = R - P + (TVA_1 - TVA_0) - (TVL_1 - TVL_0) \quad (4)$$

where

R = Receipts

P = Payments

TVA_0 = Opening tax (or legislated) value of assets

TVA_1 = Closing tax (or legislated) value of assets

TVL_0 = Opening tax (or legislated) value of liabilities

TVL_1 = Closing tax (or legislated) value of liabilities

The conceptual similarities between CI in (1) and NI in (3) should be obvious – the essential difference being a move to *tax* the value of net assets – assuming that net cash flows are always comprehensive. Because TI in (2) is different from NI in (3), and because of the requirements that the RBT proposed reforms should be revenue neutral both in aggregate and for individual companies, adjustments were necessary to replicate the outcome from the current system as reflected in TI. As a result, TVM allows NI in (3) to be adjusted in such a way as to reflect current policy decisions and the carrying forward of losses:

$$ANI = NI \pm TLA - UTL \quad (5)$$

where

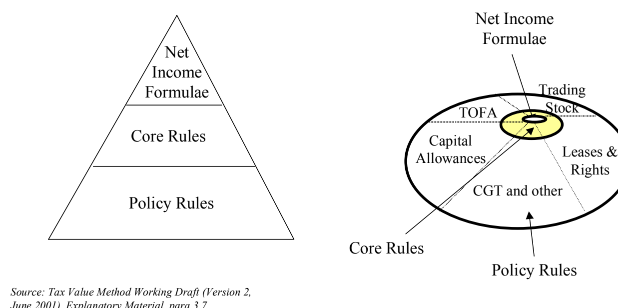
ANI = adjusted net cash income

TLA= income tax law adjustment (as per Policy Rules)

UTL= unused tax losses

Operationally, TVM adopts as its base, ANI, where TLA and UTL are designed to produce an outcome which is effectively equivalent to TI for individual companies. Figure 2 demonstrates the conceptual approach adopted in the drafting of the legislation associated with TVM. The Core Rules in the TVM tax law involve defining (4) – the net cash income concept (NI). Deviations from these Core Rules do not corrupt the principles underlying the TVM legislation. This is because the core rules define the scope of the company income tax law and are distinct from Policy Rules which are designed to meet specific government policy requirements. It is under these Policy Rules that TLA and ULA assume significance. The current goal is for the TLA and ULA adjustments to NI to replicate the outcome from the current company income tax, resulting in the ANI base which is not dissimilar from TI. Since TLA and ULA are not Core Rules, they can be changed without comprising the core rules underlying NI. In essence, the Core Rules seek to achieve the RBT goal of economic neutrality while the Policy Rules reflect non-neutralities imposed by government policy decisions.

Figure 2 TVM



Source: Tax Value Method Working Draft (Version 2, June 2001), Explanatory Material, para 3.7

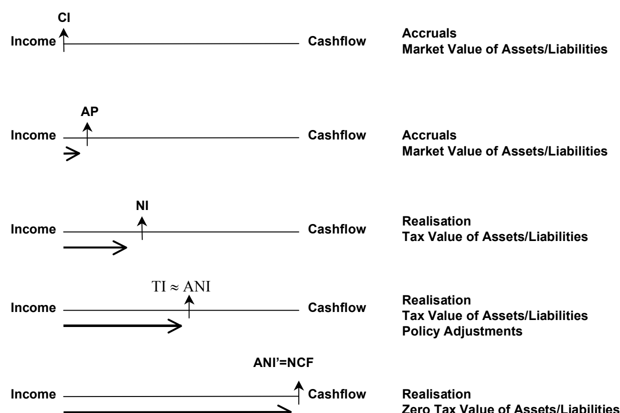
In summary, CI ≈ AP ≠ NI ≠ TI ≈ ANI.

It is these Core Rules which will need to be understood and tested and that lie at the heart of TVM. Changes in the Policy Rules can be expected to change as the particular priorities of different governments change, resulting in different tax regimes in terms of their economic effect – but without changing the Core Rules which underlie TVM. Will the Core Rules ever change? There is no real reason why they will not and herein lies a weakness in TVM. After all, when the Core Rules define NI, this results in TVNA≠VNA, so there is no reason why TVNA might not be redefined some time in the future. Probably the most tantalising prospect is the situation where TVNA=0. In this case we have moved from CI to NCF as the base - suddenly we have a cashflow base defined in our Core Rules. Equally interesting is the other extreme where TVNA=VNA, yielding NI=CI - or defining TNA so as to yield NI=AP. In an ideal world, methodological rigour would imply that if we are to have income as our preferred tax base, then CI should be defined in the Core Rules and all subsequent deviations defined in the Policy Rules.

Figure 3 present a schematic representation of the way that the Policy Rules in TVM progressively erode the comprehensive income (CI) base. This erosion can extend as far as to result in the effective operation of NCF as the base.

The similar impact of TI and ANI at the company level has obvious implications for the economic impact of the introduction of TVM. In effect, the assumption of overall revenue neutrality and the replication of the current systems' Policy Rules must mean that the impact of TVM can be expected to be marginal (since TI ≈ ANI). However, this replication of the current system will not be total and therefore there is the potential for differential impacts on different types of businesses. It is to this differential economic impact that we shall turn our attention in the remainder of this paper.

Figure 3 Progressive Erosion of CI with TVM Core and Policy Rules



3 BENCHMARK CRITERIA FOR CAPITAL TAXATION IN A GLOBAL ECONOMY

The key question now is just how we should go about evaluating the impact on companies of replacing TI with ANI. The answer lies in developing a set of criteria capable of defining what constitutes good tax design and evaluating the performance of the two company tax regimes against that criteria.

Two basic approaches could be adopted when evaluating a tax system or when proposing tax design improvements. One is to identify a set of design criteria which if satisfied, constitutes good tax design. Table 1 outlines the traditional interpretation of this criteria. Broad concepts such as the requirement for the tax system to be economically efficient are not easily given practical content. Concepts such as equity are even more problematic because what is equitable will vary widely depending up community preferences and therefore will vary depending on political persuasion. Moreover, because each criteria is often in conflict, what constitutes good tax design overall is problematic. If the good tax criteria is difficult to make operational then guidelines on what reforms are good reforms is problematic.

Table 1 Good Tax Design Criteria

	Criteria	*Description*
1	Economic efficiency	The tax system is neutral in the economic impact;
2	Equity	The burden of taxation should be clearly distributed;
3	Simplicity	Tax administration and tax compliance should not be onerous;
4	Certainty and transparency	Tax legislation and tax liabilities should be certain and easily determined;

5	International competitiveness	The tax system should be attuned to the international economic environment;
6	Transitional issues	The transition to any new tax system should not be so disruptive as to compromise the case for the new tax system;
7	Flexibility	The tax system should have scope for use as a discretionary instruments of economic management;
8	Growth	The tax system should enhance and not inhibit growth.

An alternative approach is to develop more practical and limited criteria which is capable of being more readily assessed in actual situations. One solution to this approach, which is implicit in the RBT deliberations on the virtues of TVM, is to focus on only one of the good tax criteria and make this concept operational by specifying a set of benchmarks for a particular tax.

In the case of the RBT deliberations on company income taxation, their primary focus was on developing a benchmark for the taxation of investment and the chosen approach was through the use of a comprehensive income tax (*investment taxation benchmark*)[11]. This benchmark was complemented with three other requirements for investment taxation: firstly, that entities should be taxed similarly (*entity taxation benchmark*); secondly, that all income regardless of source or form should be treated equally *(international taxation benchmark)*; and thirdly, that any market intervention should be efficiently targeted and transparent (*tax incentive benchmark*).

Clearly, the focus here is on the tax criteria of economic efficiency. Starting with the assumption that comprehensive income is the preferred company tax base[12], Table 2 sets out to restate the economic efficiency benchmark criteria for a company tax into one which is operational and capable of being utilised when evaluating the impact of the TVM proposal on the micro and macro economy.

Table 2 Company Tax Benchmark

	Criteria	*Description*
1	Funding neutrality	Do not distort the decision on how to fund a business (eg debt vs equity)
2	Risk neutrality	Permits risk offset and adjustment
3	Business structure neutrality	Incorporated and unincorporated companies treated similarly (RBT's *entity taxation benchmark*)
4	Net Income neutrality	Neutral in its treatment of different income and expenditure sources and asset and liability types
5	Payout neutrality	Neutral between dividends and retentions; and neutral in its impact on financial innovation (bifurcation vs aggregation)

[11] RBT(1999a), p.12

[12] This approach sidesteps the debate in Meade(1978) over the preferred company tax base and follows the approach adopted in RBT(1999a), Ch 6.

6	Taxpayer neutrality	Incentives to different groups should result in the same outcome for individuals whatever structure is invested in
7	Capital import/export neutrality	Benefit to resident and offshore investors should be similar. (RBT's *international taxation benchmark*)
8	Institutional neutrality	No prejudice or favour by government to sectors or groups (and if so, any market intervention should be efficiently targeted, transparent and costed). (RBT's *tax incentive benchmark*)

Lets now examine how TVM performs against the above criteria relative to the current company tax system and what is likely to be the expected impact on companies and the broader economy from this reform?

4 MODELLING TVM

The Board of Taxation has indicated that:

> The Board has developed broadly a two-stage strategy for advancing the development and evaluation of the TVM.
>
> The first stage will centre on developing a draft legislative framework sufficient to demonstrate and effectively test the TVM concept.
>
> The second will focus on evaluating and quantifying the likely transitional and on-going costs and other aspects of compliance with TVM based legislation. Evaluation will also extend to testing the robustness of the concept in terms of its capacity to accommodate future changes to the law and to maintaining the law's integrity.[13]

What is instructive is that despite the detailed work of the RBT and now of the Board of Taxation, modelling the impact of TVM has taken backstage to tabling the draft legislation. The reason probably lies in how to model the impact of TVM reforms because of their marginal impact on companies and in turn on the economy. This does not deny the importance of such a study – only that the priority with TVM would appear to lie more with improving the integrity of current tax legislation than with introducing changes which result in significant economic gain.

This paper will not seek to do what other before it could not do and that is to undertake an empirical analysis of the microeconomic and macroeconomic impact of TVM. Rather, our approach will be descriptive, seeking to identify those factors which are likely to impact on companies and in turn on the economy resulting from the failure to meet the criteria detailed in Table 2. The descriptive analysis below will first focus on this impact at the level of the company, and then go on to conjecture at its impact in the macro-economy.

However, we shall first outline the critical issues the introduction of TVM has for business. With this knowledge, we can better assess how TVM will impact on individual companies and on the broader economy.

[13] See <www.taxboard.gov.au/index.htm>

The TVM issues of importance flowing from industry consultation following the release of RBT identified in a Treasury/ATO discussion paper were[14]:

- treatment of expenditure that gets an immediate deduction;
- treatment of routine rights and obligations;
- impact of the TVM on compliance costs;
- implication for international operations of companies;
- treatment of private receipts, payments, assets and liabilities; and
- how capital gains tax fits into TVM.

Ultimately, the debate over TVM appears to have little to do with the economic benefits arising from such a reform and almost every thing to do with replicating the outcomes from the current system while endowing the new system with economically sound theoretical foundations. With these foundations, the legislation is seen as having the potential to be simpler and better able to respond to the changing economic environment in which companies operate. The threat is however that the Policy Rules have the potential to undo some of this simplification, an issue we return to later.

Not surprisingly, the Treasury/ATO approach post RBT has been to constantly react to the various criticisms leveled at TVM by the business sector and by the tax and accounting profession. Probably the most profound admission by the Treasury and ATO has been that introducing TVM will result in substantially increased compliance costs in the transition offset by the expectation that in the longer term, substantial administration and compliance benefits are expected[15]. As the TVM EM(June 2001) itself notes:

> 3.25 Lower compliance and administration costs should result from a law that is easier to understand and apply. This should impact directly on the costs of those who use or administer the law. However, one of the main issues of concern is the transitional cost of learning and applying the law for the first time.
>
> 3.26 A significant issue is, if the Tax Value Method can realise the benefits discussed above, would those benefits outweigh the transitional cost of reform.

While compliance and administrative cost issues have attracted comment, little attention has been given to the economic benefits of TVM. It is to this issue that we now turn. The approach taken will be to use a descriptive rather than empirical analysis because the tax reforms are infra-marginal in nature and cannot be easily evaluated using economic models.

5 IMPACT OF TVM ON COMPANIES

Let us first examine the performance of TVM against the benchmark criteria outlined in Table 2. Table 3 provides a brief overview of the performance of TVM against this criteria. What is clear is that – not surprisingly – TVM's benefits are more long term and potentially elusive.

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[14] See the discussion in: *The tax value method: Discussion paper on issues raised in consultations during December 1999 and January 2000*, Commonwealth Treasury and the Australian Taxation Office, February 2000, p 4.

[15] *ibid* Section 6. The cynicism of the tax and accounting profession is not without foundation. The tax law improvement program (TLIP) in the 1990s was also supported to have had longer term benefits but these have not materialised and it is arguable that the legislation is now more complicated because the TLIP program was not completed.

From an economic point of view, the scope for TVM to better cope with increasing financial innovation is a particular strength, as is the separation between Core Rules and Policy Rules which will ensure greater transparency in relation to government intervention in the basic operation of the company income tax.

While the observations in Table 3 are general, determining how TVM can be expected to impact on individual companies is more problematic. After all, tax reforms such as the introduction of TVM will impact on companies according to their specific circumstances and the nature of the proposed reforms.

For example, the changes in relation to black hole expenditures will clearly have no implications for businesses where such expenditure is not an issue. However, as Figure 2 below shows, this does not imply that the change in the treatment of these expenditures will necessarily always be irrelevant for this business. While immediately after the introduction of TVM (in period t=1) black hole expenditure may still be zero, this may not be the case after the first (in period t=2) and subsequent rounds response (up to t=3) to TVM because such expenditures might eventually be undertaken by this business.

The challenge for those seeking to assess the economic impact of TVM is to assess not just its first round impact but the longer term (or the second and subsequent round) impacts which might arise because the company has found advantage in incurring these expenses as part of its business practice.

Recognition of this all-important behavioural response is critical to a full and proper assessment of the impact of TVM on businesses. The problem is however, that these behavioural responses to the introduction of TVM are difficult if not impossible to determine *exante* – despite the importance of such responses to the case for TVM.

Likewise, the behavioural response of international capital to TVM cannot be overlooked but is equally problematic.

There are numerous other issues which need closer examination in relation to the impact TVM and just some of these are listed below:

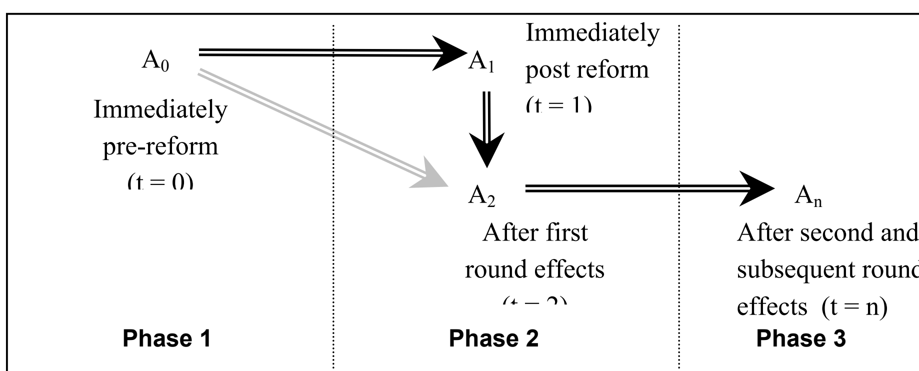
- Impact on domestic as compared to multinational companies;
- The impact of compliance costs (one-off and on-going) on business profitability;
- The impact of TVM on SMEs and its relationship to a Simplified Tax System (STS) for small businesses;
- How TVM is likely to impact on different sectors (finance, personal services, manufacturing);
- The implications of any divergence between accounting and TVM concepts;
- The magnitude of the likely behavioural response arising from the introduction of TVM;
- The likelihood and potential implications of changing the current tax incentives structure implicit in the TVM Policy Rules including changes such as adopting the RBT recommendations dealing with the taxation of financial arrangements.[16]

Table 3 Company Tax Benchmarks and TVM

[16] See Section 9 of RBT(1999b).

	Criteria	*Description*	*TVM reforms (Core Rules)*
1	Funding neutrality	Debt versus equity neutrality	Issue not addressed
2	Risk neutrality	Permits risk offset and adjustment	Black holes expenditure deductible
3	Business structure neutrality	Incorporated and unincorporated companies treated similarly (RBT's *entity taxation benchmark*)	
4	Net Income neutrality	Neutral in its treatment of different income and expenditure sources and asset and liability types	Greater scope with *Core Rules* but potentially lost with *Policy Rules*
5	Payout neutrality	Neutral between dividends and retentions; and neutral in its impact on financial innovation (bifurcation vs aggregation)	Imputation retained TVM has scope to handle financial innovation
6	Taxpayer neutrality	Incentives to different groups should result in the same outcome for individuals whatever structure is invested in	Conduit Theory[17] not operational for companies
7	Capital import/ export neutrality	Benefit to resident and offshore investors should be similar. (RBT's *international taxation benchmark*)	Adoption of different income base to other countries
8	Institutional neutrality	No prejudice or favour by government to sectors or groups (and if so, any market intervention should be efficiently targeted, transparent and costed). (RBT's *tax incentive benchmark*)	*Core Rules* as they apply to incorporated enterprises is neutral but not *Policy Rules*. Moreover, any move to entity taxation might appear neutral but it is working against Conduit Theory

Figure 3 Phases in examining the economic impact of tax reforms



Phases		*Description*
1.	$A_0 \Rightarrow A_1$	Immediate impact with no behavioural response ie static (or impact) analysis (in period t=1)
2.	$A_1 \Rightarrow A_2$	Each company elicits a behavioural response but this has not

[17] Conduit Theory asserts that all income should be taxed in the hands of individuals and that as a consequence, any tax benefits (such as accelerated depreciation) accruing to a company should pass directly through to shareholders. This is not presently the case with the taxation of companies but is the case with the taxation of trusts. The later attribute would be lost if the system of entity taxation regime proposed in Treasurer(1998) was adopted.

		been responded to by other companies (in period t=2)
3.	$A_2 \Rightarrow A_n$	All companies work through their response both to the reforms and to the response of other companies to those reforms (by period t=n).

The significance of the last point should not be lost in the TVM debate. In particular, the issue here is how the TVM Policy Rules might ultimately be changed and whether TVM has a longer-term objective – which it undoubtedly does have – such as the overall simplification and rationalisation of the current array of Policy Rules. Any ultimate changes to these Policy Rules will undoubtedly have an economic impact which should be noted and factored into the current debate – which they currently are not because they have not been raised to date as an issue for consideration.

The TVM EM(June 2001) also identifies other factors which might influence the impact of TVM:

> 2.36 Also, inherent in the Tax Value Method is a more consistent treatment of assets and liabilities. This consistent treatment will do these things:
>
> - *Standardisation.* The disparate treatment that currently applies to different kinds of assets and liabilities (e.g. depreciating assets as compared to CGT assets) will be standardised. This standardisation in turn may alter tax outcomes in some cases (e.g. consistent timing of recognition regardless of asset type). The comprehensive recognition of liabilities under the Tax Value Method will also standardise the timing of recognition of gains and losses for the provision of services and the disposal of assets.
> - *Complete description of the income tax base.* A completely described tax base, rather than a number of separate regimes trying to cover the same ground, will prevent gaps. For example, under the Tax Value Method expenditure black holes will be avoided so that tax relief for all non-private expenses will be given at some time. Similarly, overlaps between regimes that are present in the current law should not arise. To the extent that the current law does not address those overlaps, current cases of double taxing (or double deductions) will disappear under the Tax Value Method.
>
> 2.37 It will be necessary, in due course, to identify and obtain an estimate of the revenue impact of these changes. This will enable their impact to be fully considered in developing the legislation, by the Tax Board and, ultimately, by the Government.

Clearly, at the microeconomic level, a case based approach is probably the only feasible method of examining the impact of TVM on companies. However as Figure 3 has already highlighted, the static analysis of the impact of TVM on business outlined in the TVM EM(June 2001) does not acknowledge the all important behavioural response by businesses to the impact of TVM nor the impact of any ultimate agenda to simplifying, streamlining or even to abolish some TVM Policy Rules.

6 MACROECONOMIC IMPACT OF TVM

The brief discussion above has highlighted the various ways individual companies could be impacted upon by TVM. The issue that remains to be addressed is how these individual impacts will cumulate to impact on the broader economy. Important additional considerations here include the implications of the:

- The impact of TVM on different sectors of the economy flowing from the behavioural response to the introduction of TVM;
- The response of international capital to TVM;
- Subsequent changes to Policy Rules not currently alluded to in the debate;
- Non-tax macroeconomic factors during transition (eg interest rates; fiscal policy response).

Estimating the impact of the above issues on the macroeconomy is problematic because such impacts would be largely based on observations flowing from estimates of the microeconomic (individual company) impact of TVM. Since estimating these company based impacts (including the behavioural response) is difficult – bordering on impossible because the net effect of TVM on companies is marginal – then the broader macroeconomic impact will be equally difficult if not impossible.

At best we are therefore left to conjecture as to the likely macroeconomic impact of TVM as well as to possible future changes to Policy Rules. Making this even harder is the fact that any currently perceived economic downsides would ultimately be addressed by ongoing revision to the draft EM and legislation. Moreover, the impact in the short run may be quite different to those in the long run. For example, increased compliance costs and uncertainty might be an added burden for companies in the short term but not in the longer term when the benefits of simplification are expected to become important positive benefit from the reform.

Another issues important at the macroeconomic level is the response of international capital to TVM, an issue on which there is still divided opinion but one could expect that if there was an issue that this would be addressed in some way prior to implementation.

7 WHERE TO FROM HERE?

Ultimately, TVM as proposed by RBT and subsequently supported by the Government, the Treasury and the ATO, would appear to be focussed more on good housekeeping than significant tax reform[18] – its primary purpose being to give the current company income tax rigorous theoretical foundations. As a result, the challenge for this paper has been to ascertain the expected economic impact of what can only be termed tax reforms with an infra-marginal economic impact. The descriptive analysis above has therefore, not surprisingly, been inconclusive in terms of its observations about the economic impact of TVM.

Some of the issues that might be more important in such an analysis and might lead to a more decisive conclusion would arise if TVM was seen as ultimately being associated with considerations such as:

- future changes to Policy Rules including changes to depreciation rates and the treatment of R&D;
- changes to the taxation of financial arrangements;

[18] There are clear parallels here with the recent indirect tax reforms which centred on the introduction of a GST. In effect, we could view the introduction of the GST and abolition of the of Wholesale Sales Tax as simply a rationalisation of the Australian indirect tax system.

- changes to the interaction of company income tax with other taxes (because no one tax can be considered in isolation from other taxes);[19]
- a move away from the imputation system of company income tax to a classical system; and
- substantial longer term reductions in compliance costs (despite increase short term burdens).

However, these are issues related to ongoing changes in the company income tax system and are not addressed in the TVM proposal. Therefore, they are beyond the scope of this paper. However, what this paper has indicated is that the case for TVM is constrained significantly by the requirement that it be a revenue neutral reform both at the company and economy-wide level.[20]

Not surprisingly, this study has failed to identify major economic gains from TVM. The reality is though that the case for TVM does not lie in major economic benefits arising from the reform – it lies in underpinning company tax law with rigorous conceptual foundations. It is here that the debate must focus and a resolution must be found for the apparent tradeoffs between issues like the short term compliance costs and the longer term potential benefits from legislative and administrative simplification.

Unfortunately, the infra-marginal nature of the TVM changes makes modelling the economic impact of these changes neither practical nor meaningful? The future of TVM clearly lies in the communication of its long term benefits for tax payers and tax administrators – the major issue now to be resolved is whether these potential long term gains *significantly* outweigh the short term implementation costs.

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[19] For example, the interaction of the company income tax with the personal income tax (Meade 1978, p.228) is potentially important here – as is the future of imputation. Reforms to the current imputation system of company income tax cannot therefore be considered independent of the personal income tax.

[20] This constraint was clearly recognised in the debate over the GST and is largely why the GST centre package of reforms were associated with significant personal income tax cuts.

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