Personal Capital Gains or Rate of Return Taxation?
A Survey of Theory in Reform Proposals

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As the theory of public finance evolves in response to new insights and empirical evidence, opportunities continually arise to modify national fiscal systems to reflect these new insights. The ultimate objective of such innovation is to improve the equity-efficiency tradeoff by making more informed choices. ...

In many ... cases our advances have left us with a less clear picture than we thought we had. ... The realisation principle is no longer a viable approach to taxation, but full accrual taxation is not yet feasible and alternatives to it face political resistance. ... In summary, our state of knowledge has certainly advanced over the past few decades, as has our ability to contribute to informed policy-making. But this contribution requires a subtle touch, for the lessons are often not simple or easily explained.

Alan Auerbach surveying the evolution of economic theory, empirical evidence and adopted policy on selected issues, including capital gains and the realization principle, from the late 1960s to 2009.¹

Introduction
To the extent that countries impose tax on the increase in value of an investment asset that is held in personal names and is not a business asset (personal capital gains), they mainly use the realisation principle, occasionally the accrual principle, and, less frequently, the presumptive return principle. OECD revenue statistics may suggest that few OECD member countries even try to collect any tax on personal capital gains but it would be a mistake to draw that inference from the OECD revenue statistics database recording that a country collects zero revenue on personal capital gains.² As the OECD itself notes, it is not possible in

¹ Alan J Auerbach, ‘Directions in Tax and Transfer Theory’ in Australia’s Future Tax and Transfer Policy Conference (2009 Melbourne) and Melbourne Institute of Applied Economic and Social Research (publisher), Melbourne Institute – Australia’s Future Tax and Transfer Policy Conference: Proceedings of a Conference (Melbourne Institute of Applied Economic and Social Research, University of Melbourne 2010) 63, 63 and 70
² The OECD revenue line item for tax on individuals’ capital gains is ‘1120 Taxes on Capital Gains’. A recording of zero may be saying no tax collected or this revenue stream is not separately identifiable. Take the example of New Zealand, one of the few OECD member countries that does not have a comprehensive capital gains tax. Line 1120 for New Zealand has zero collection of revenue recorded for each of the selected years from 1965 to 2013 (OECD, Revenue Statistics 1965-2013 (OECD 2014) 212). The reason for this row of zeros is not an assessment that New Zealand does not collect any tax on personal capital gains. Nor is it a judgment that New Zealand does not collect any ‘good’ revenue on personal capital gains because it all results from poor design features such as the asymmetrical treatment of losses and gains. [Both the amount and quality of revenue are, of course, interesting empirical questions]. No, the reason for the zeros is because New Zealand revenue statistics do not allow capital gains tax to be separately identified. New Zealand may not tax capital gains comprehensively but it does tax personal capital gains using several methods. Portfolio holdings of most foreign company shares owned by New Zealand resident individual shareholders are taxed using a presumptive return method. It takes increases in the value of the shares into account in setting the ordinary presumptive rate of return of 5% pa, which is applied to the market value of the shares at the beginning of the income year. To the extent that this rate is higher than the actual rate of dividend return earned each year by New Zealand shareholders in foreign companies, it will tax capital appreciation during the year. In the case of certain taxpayers, including an individual, it is possible to apply the actual rate of return if it is lower than 5% in that year. But even here the actual return must be measured to include the accrued capital gain in the year, not just dividends received in the year. Secondly, above a liberal threshold, financial arrangements held by individuals are taxed using the accrual principle. Below the threshold, all of the return on a financial arrangement is taxed on realisation, maturity or remission, without distinguishing between capital and
many countries to identify tax imposed on capital gains separately, in which case capital gain tax collections are included in broad income tax categories. Fortunately, a detailed picture of the different ways OECD countries taxed capital gains on shares and real property earned by resident individuals in a domestic setting as at 1 July 2012 is available in a recent OECD working paper. It provides a helpful classification of capital gains tax treatment for gains on shares and on real property in OECD countries. Compared with Australia, the Netherlands and the United Kingdom, New Zealand is shown in this OECD working paper to have imposed lower combined corporate and individual statutory tax rates on gains on shares and real property in mid-2012.

Key influences on future capital gains tax reform other than current policy and practice include systems of political decision making, economic and technological change, ideology and, of course, ideas. It is this last influence that this working paper considers. In general, the task of understanding and explaining the contribution of theoretical and empirical research to informed tax policy-making has not become easier over the last 40 or more years, as Alan Auerbach concluded in the quotation that opens this working paper. And, specifically in relation to the taxation of capital gains, Auerbach’s overall assessment suggests we are at a political impasse: ‘the realisation principle is no longer a viable approach to taxation, but full accrual taxation is not yet feasible and alternatives to it face political resistance.’ This assessment is one made on the back of Auerbach’s long experience researching in this area, as well as connecting economic theory to policymaking and connecting economics with law. He is one of America’s leading public finance economists. His research on the taxation of capital income, including capital gains, spans more than three decades and is frequently cited in the public finance literature. Of revenue. A third example is that profits from the disposal of personal property (such as shares) and land acquired by an individual for the purpose of resale are taxed using the realisation principle.

3 OECD, supra note 2, 325
4 Michelle Harding, ‘Taxation of Dividend, Interest, and Capital Gain Income’ (OECD Taxation Working Papers No 19, 2013) <http://dx.doi.org/10.1787/5k3wh96w246k-en> at 5-7, 29-46. See especially the discussion of: personal capital gains taxation in OECD countries at pages 32 to 39 and combined statutory tax rates and rates of return at pages 39 to 44; the tax payable on capital gains on property at the individual level in Table 10 on page 31; the combined corporate and individual statutory rates on gains on shares and property in Table 16 on page 45; and, the combined corporate and individual statutory rates on gains on shares and property compared to OECD average tax rates in Figure 14 on page 46.
5 Harding, supra note 4, Table 16 at 45
6 Harding, supra note 4, 29-32, 41, 45, 46. For capital gains on shares, the estimated combined statutory tax rates in Australia, the Netherlands, and the United Kingdom were higher than the OECD average tax rate while in New Zealand the combined statutory tax rate was lower than the OECD average tax rate. For capital gains on real property, the estimated combined statutory tax rates in Australia, the Netherlands, and the United Kingdom were higher than the OECD average tax rate while for New Zealand, again, the combined statutory tax rate was lower than the OECD average tax rate.
7 Auerbach, supra note 1, 70
particular relevance for this working paper on the influence of economic theory on tax reform proposals, Auerbach’s assessment also draws on his experience contributing to informing policy making in his home country, the United States, and in recent reviews of at least three other national tax systems considered in this working paper: the Henry Review in Australia,9 the Tax Review 2001 in New Zealand;10 and, the Mirrlees Review in the United Kingdom.11 The value of Auerbach’s writing for the purposes of this working paper is further enhanced by his long commitment to communicating insights from economics to tax specialists who are not economists and his scrupulous articulation of assumptions, even though some of the analysis and assumptions may not always be easily understood or accepted by those of us not trained in economics.12 Finally, there is something reassuring about a leading scholar in a field who continues to take great care in forming judgments and who is prepared to acknowledge the current limits of the state of knowledge in their area of expertise.

Auerbach’s survey for the Henry Review is one written by a public finance economist who begins from economic theory, then moves to empirical research and, in some instances, on to adopted tax policy. As it concerns a number of issues, its consideration of each one of them is necessarily brief. I have taken a different tack. I started from public tax review proposals to reform current personal capital gains policy and law and thought back to economic theory and forwards to likely tax policy and law design issues for lawyers in the future. Public tax reviews are a key place where engagement between experts from different disciplines takes place and a choice must be made between different approaches to evaluate and reform real world tax systems. These review panels are often made up of people with training and experience in economics and law, as well as other disciplines. Another place where this decision has to be made is in official reports that are the product of experts with different training and experience.

Furthermore, public tax review and official report analysis and recommendations can influence the subsequent tax debate nationally and abroad, the research agenda and approach of officials13 and academics, and national tax reform some years into the future.


9 Auerbach, supra note 1


12 Alvin Warren, ‘Commentary on the Choice between Income and Consumption Taxes: A Primer’ in Alan J Auerbach and Daniel Shaviro (eds), Institutional Foundations of Public Finance: Economic and Legal Perspectives (Harvard University Press 2008) 54. Alvin Warren is a legal scholar who himself has contributed greatly to the capital income taxation debate over many years.

13 In another context, Ian Dickson and I have noted that the 1978 Meade Report on the United Kingdom tax system may not have answered the question whether New Zealand should adopt a VAT or retail sales tax in the 1980s but it ‘had an immense influence on the development of tax policy thinking in New Zealand in the years following its publication. It was much pored over, studied, debated, and quoted at length in officials’ reports to New Zealand ministers. It provided guidance about how problems relating to the taxation of individuals and businesses, and wealth, should be addressed. Under Meade’s influence, the formulation of tax policy advice became systematic and principles-based.’ Ian Dickson and David White, ‘Commentary on Value
Finally, leading public finance and tax law scholars have often been members of these tax reviews or have provided them with substantial expert advice. A pattern of certain theoretical insights being discussed or accepted widely by public tax reviews and official tax reform statements may be one indicator of the direction of future tax reform design and what are likely to be some of the personal capital gains tax law design issues for lawyers. On the downside, unless reviews or reports by groups report different views on an issue, as the New Zealand Tax Working Group did (see the discussion in New Zealand in the penultimate section on public tax reviews and official reports), they may just reflect the lowest common denominator acceptable to all involved in writing the report and then much turns on the membership of the review or report writing group.

Most of my tax career has been spent working on tax policy design and tax law reform, including the taxation of capital income and capital gains. In the late 1980s, I worked on a proposal to tax residents on returns from their foreign company shares on accrual and on a comprehensive review of the taxation of income from capital. More recently, I have been involved in reviews of the taxation of capital gains in New Zealand and Australia. Much of the time I was working in multi-disciplinary teams, which included economists, lawyers, accountants and, sometimes, political scientists. Most of the teams were led by economists. I may have been a lawyer working on the legal issues of a project but I could not have done my job well without reading and thinking about the different theoretical and empirical approaches taken by economists to issues of public finance and how these approaches were evolving.

This working paper, then, contains the reflections of a former tax policy official and a current tax law academic on the influence of economic theory on proposals to reform personal capital gains taxation. It does not cover business or corporate capital gains. It is,

Added Tax and Excises’ in Mirrlees, supra note 11, 387 at 390-91. Although we worked in the New Zealand Treasury tax policy branch at different times, our individual experience taken together covers much of the period from the late 1970s to 2000.

The comparative-value basis was an accruals method proposed by the New Zealand government to tax foreign income derived by a New Zealand resident from their interest in a non-resident company or trust and implemented in a modified manner following consultation with the public. See Roger Douglas, Consultative Document on International Tax Reform (Government Printer 1987); Arthur Valabah and others, International Tax Reform, Part 1: Report of the Consultative Committee (Government Printer 1988); Arthur Valabah and others, International Tax Reform, Part 2: Report of the Consultative Committee (Government Printer 1988). For a short review of New Zealand policy development and changes in this area over 20 years, including the move for most portfolio foreign share investors from an accrual capital gains tax method to a presumptive tax method, see David White, ‘Income and Consumption Taxes in New Zealand: The Political Economy of Broad-Based, Low-Rate Reform in a Small Open Economy’ in John G Head and Richard Krever (eds), Tax Reform in the 21st Century: A Volume in Memory of Richard Musgrave (Kluwer Law International 2009) 95 at 109-110, 128-130

David Caygill, Consultative Document on the Taxation of Income from Capital (Government Printer 1989)


however, increasingly necessary to consider personal capital gains within the broader context of personal capital income, as a result of the changing conceptualisation of the issues in this area (see the discussion below in this section). Secondly, it focuses on the influence of two major economic theoretical approaches on tax reform proposals in this area: the comprehensive income tax concept and optimal tax theory. It does not, for example, consider political economy or public choice theory. Thirdly, it reflects on the influence of these two theories in the reports of selected public tax reviews and official statements on tax reform proposals in six countries and in three tax policy reports prepared by the OECD.

The next section makes some observations about the part that economic theory can play in tax policy analysis in general. Following this, a short account of the historical development of comprehensive income and optimal tax theory provides a timeline and essential background. The influence of these two theoretical approaches on analysis and proposals in selected public tax reviews and official reports in the six countries is then discussed. The picture that emerges from taking this perspective, which is one step short of policy adopted in tax legislation, is even less clear than that provided by Alan Auerbach in his 2009 survey of the evolution of tax and transfer theory, evidence and adopted policy.

If I understand Auerbach’s recent writing correctly, he is arguing that from the 1960s the main theoretical debate about capital income taxation has moved from comprehensive income to optimal tax theory in simple models suggesting no capital income taxation and now to how some form of capital income taxation should occur, without returning to the comprehensive income concept. Looking at the issue from the perspective of selected public tax reviews and official tax reform statements in six countries and selected tax policy reports of the OECD shows a more mottled picture. First, the different legal and economic conceptualisations of the issue confuse the picture. Second, both of these theories are still being used in reform analysis and proposals for personal capital income and gains taxation, along with several ‘rules of thumb’, such as ‘neutrality’ and ‘broad base-low rate’. Section five contains conclusions.

But before we start, we should note the evolving conceptualisation of the issue, which can cause some confusion for those coming fresh to the economic literature and to proposals to reform the taxation of personal capital income including capital gains. It is helpful to

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18 In contrast to the 1978 Meade Committee report, which they were updating more than 30 years later, the Mirrlees Review editors commissioned a chapter on the political economy of tax reform and institution design. They sought lessons from the theoretical and empirical research on the political economy of tax reform, as well as policy issues, to understand how economics and politics mix in tax and transfer policy making, implementation and administration so that they might take that into account in making their proposals. See James Alt, Ian Preston and Luke Sibieta, ‘The Political Economy of Tax Policy’ and the commentaries by Peter Riddell, Guido Tabellini for and Chris Wales in Mirrlees, supra note 11, 1204. It is fair to say, however, that the final report focuses much more on the economics of tax design. James Mirrlees and others (eds), Tax by Design: The Mirrlees Review (OUP for Institute for Fiscal Studies 2011) (hereinafter ‘Mirrlees Review’) <http://www.ifs.org.uk/publications/5353> accessed 10 March 2015. See also Torsten Persson and Guido Tabellini, Political Economics: Explaining Economic Policy (MIT Press 2000)


20 Auerbach, supra note 1
distinguish three different conceptions of the issue: first, a legal conception of income and capital gains, largely based on the realisation principle; second, an economic conception of income and capital gains that is sometimes called ‘economic income’, largely based on the accrual principle; and third, a more recent economic conception of capital income that decomposes it into several constituent parts, with no one of the parts being called ‘capital gains’.

Nowadays, ‘capital gain’, using either the first or second conceptions, is more often used in analysis of current tax law and policy and changes that should be made to those rules than it is in the normative theory of taxation. Indeed, the legal conception of income and capital gains has developed from describing and analysing the income taxes in most countries, which still mainly use the realisation principle to the extent that they tax an increase in value of assets. The economic definition of income, on the other hand, derives from the Haig-Simons definition of personal income and requires an annual measurement of the well-being of a person (their consumption and change in wealth) including the application of the accrual principle or an accrual-equivalent method to tax increases in the value of assets.

Modern normative theory, however, will more commonly distinguish between two, three or four constituent parts of capital income. In the case of the four-fold distinction, they are: the ‘normal return’, which compensates investors for deferring their consumption, sometimes also known as the ‘risk-free return’, the ‘return to waiting’ or the ‘safe rate of interest’; the ‘return to risk taking’, which compensates investors for bearing ex ante risk when their return on a project is uncertain, sometimes referred to as the expected ‘risk premium’; the ‘super normal return’, which compensates investors for their unique skills or ideas, and is sometimes known as ‘economic profit’ or ‘inframarginal returns’; and, the ex post ‘unexpected return’ from (good or bad) luck, which is the difference between the actual and expected return.

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21 See, for example, the work of a prominent US law and economics academic: Louis Kaplow, *The Theory of Taxation and Public Economics* (Princeton University Press 2008) xvii, which aims to provide ‘a unifying conceptual framework for the normative study of taxation and related subjects in public economics.’ It has a chapter on theory relating to the taxation of capital but does not use ‘capital gains’ as an analytical tool. According to the index, there are just two references to ‘capital gains’ in the book. They are both to current law.

22 See the subsection below entitled ‘The Comprehensive Income Tax Concept’.

23 Sometimes, capital income is divided into three types of return: the normal return; the risk return; and, the extra return, which combines the supernormal and unexpected return concepts. See Henry J Aaron, Leonard E Burman, C Eugene Steuerle, *Taxing Capital Income* (Urban Institute Press 2007) xiii. The Mirrlees Review proposals in relation to the taxation of household savings divided returns into two: the normal return; and the excess return. Mirrlees (2011), *supra* note 18, 298. For an example of a prominent legal academic using this conception in designing a tax that collects tax on normal returns at the investor level and tax on economic rents at the business enterprises level, see Edward Kleinbard, ‘Designing an Income Tax on Capital’ in Aaron, this footnote, 165

This decomposition of the return to capital is often used to understand the difference between income tax and consumption tax treatment,\textsuperscript{25} for example, but it is now also beginning to be used as the foundation for tax policy and law proposals where previously the capital gains concept might have been used in whole or in part. Two examples are the Dutch presumptive income tax levied at 1.2\% on selected portfolio investment and savings held by individuals and the 4\% statutory risk-free return method of taxation proposed by a tax reform commission in New Zealand in 2001 for the taxation of certain assets, entities, or a mixed regime that applied both to specified entities and shares in them. On the other hand, the Australian Henry Review considered deemed return or presumptive tax methods have the disadvantage of not taxing any ‘above-normal returns or economic rent’\textsuperscript{26} and, in effect, proposed reduced taxation on the normal return to capital through a 40\% savings income discount. And, the United Kingdom Mirrlees Review proposed to leave the normal risk-free return to personal capital income free of tax but to tax returns above the normal risk-free return (what they called ‘excess returns’).\textsuperscript{27} All four examples will be discussed in the penultimate section of this working paper.

**Economic theory and tax reform**

‘Everyone is in the grip of some theory - even those who affect to despise theory’, as the British economist John Kay expressively put it, recalling a senior policy administrator asking why it was not possible simply to define income using common sense.\textsuperscript{28} Before we turn to examine the influence of the two specific economic theories, it might be helpful to consider more generally the part that economic theory can play in tax policy analysis: first, the role of economic theory in relation to a particular tax issue, such as personal capital gains (the iterative nature of the policy process, the role of value judgments and the role of rules of thumb); second, the role of economic theory in thinking about a tax problem and proposed solutions in the context of the whole tax and transfer system; third, the role of broader national public policy factors and theory in tax reform; and, finally, the role of ideas in creating the climate of opinion in which tax reform proposals are considered and either accepted or rejected.


\textsuperscript{27} Mirrlees (2011), *supra* note 18, 301-03

Economic theory and reform of a tax problem

First, we consider the role of economic theory in relation to reform of a particular tax issue. There is an evolving and complex interplay between economic theory, statistics and other data, tax policy, law, practice and administration. The policy process is an iterative one, sometimes starting from theory, sometimes from statistics and data and sometimes from policy, law, practice or administration. When I worked in the New Zealand Treasury tax policy branch, the theoretical and empirical literature was keenly read and debated, along with the tax practitioner literature and the results of community consultation. Many stakeholders, including the public, politicians, practitioners, officials, nongovernmental organizations and academics, had theories on a controversial topic like capital gains taxation. One of the tasks of officials was to test these theories against all available sources of data, including statistics and legal, administrative and technological constraints. I recall lively debates on the helpfulness of the comprehensive income tax and optimal tax frameworks, and insights generated by particular models developed within those frameworks, for identifying the right policy questions and systematically thinking through the issues in relation to taxing capital income and gains in a small, open economy such as New Zealand.

A complication in this case is the fact that capital income taxation stands right at the centre of a key tax policy issue: should the personal tax base be income or consumption? How capital income, including capital gains, is taxed is the major difference between these two options for the personal tax base. Indeed, in one of the key chapters of the first volume of the Mirrlees Review, James Banks and Peter Diamond argued that rather than framing the question as whether the personal tax base should be income or expenditure ‘a better question is how to tax income from capital, on the assumption that there will continue to be some annual ‘progressive’ taxation of earnings in which the share of earnings taken in tax increases as earnings increase.’ 29 Naturally, there is a vast literature with much disagreement on this central topic of taxation of personal capital (or personal or household savings, as it is sometimes known).

In part, differing views may be the result of differing value judgments and choices we make about the issues we examine, the data we collect, the analytical approaches we take, the assumptions we find acceptable in relation to a research question, and so on. Sir James Meade, a Nobel Laureate in economics who chaired a highly acclaimed review of the United Kingdom tax system in the 1970s, 30 provides a telling example. A member of the Meade Committee has written recently:

If it was not these arguments from optimal tax theory ... which led the Meade Committee to favour expenditure taxation, what was the rationale of the Committee’s preference? In truth, it was clear from the beginning that the Committee would favour an expenditure tax, and I understood from my very first discussion with the chairman that that the task was less to provide objective analysis than to make the case for expenditure tax and to deal with the operational issues that arose. ... [E]xpenditure tax [was] both the starting point and the conclusion. I think that at a visceral level, James Meade believed in the moral case that people should be taxed on what they took out, not on what they put in. This is not

29 James Banks and Peter Diamond ‘The Base for Direct Taxation’ in Mirrlees, supra note 11, 548, 549
30 Meade Committee, The Structure and Reform of Direct Taxation (Institute for Fiscal Studies 1978)
really a satisfactory argument, as he knew. But I have no doubt that he, along with most of
the Committee, came to the issue from this sort of perspective. The taxable capacity was
key. For the Meade Committee, as for most ordinary people, questions of fairness and
taxable capacity would seem to be of critical importance—even exclusive importance—in
determining the household tax base.31

John Creedy has written extensively on the inevitable and substantial part value judgments
play in tax and transfer system design and, for example, argues that there should have been
more discussion of the nature and role of value judgments in tax design in the Mirrlees
Review of the United Kingdom tax system.32

Economic theory often does not provide clear and direct guidance on a tax design issue. In
these circumstances, policymakers frequently use broad ‘rules of thumb’. It should be
stressed that these are merely sensible ‘guidelines’ to follow unless there is good reason not
to do so. For the Mirrlees Review, for example, there were three rules of thumb or
guidelines: ‘Other things being equal, a tax system is likely to be better if it is simple,
normal, and stable’.33 As the Mirrlees Review explained, these guidelines are not objectives.
As a guideline, treating all forms of savings the same may promote ‘neutrality’ in relation to
how savings occur but policymakers may conclude that there are good reasons, on balance,
to treat particular savings, such as pension savings, more favourably. Another broad rule of
thumb followed by many OECD countries, including New Zealand,34 is the ‘broad base low
rate’ approach. An OECD report points to theoretical and empirical evidence suggesting ‘in
most cases the benefits of a broader tax base reform outweighs its costs’ but argues that
this requires empirical proof for each reform, taking into account national circumstances
and the means to achieve equity objectives.35

**Economic theory and the tax and transfer system**

Secondly, at a broad level, theoretical and empirical research can provide a framework for a
more coherent design of taxes and transfers, which can enable a government to better
meet its strategic objectives. Too many tax systems suffer from incoherent policy, law and
administration. There is little rationale for the different tax treatment of various forms of
personal savings, including capital gains, for example. Too often, the individual parts do not
work together to achieve the overall goals of government. There is a poor relationship

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31 John Kay, ‘Commentary on the Base for Direct Taxation’ in Mirrlees, *supra* note 11, 656, 659
32 See John Creedy, ‘Reflections on Tax by Design’ (2011) 32(3) Fiscal Studies 361, 366-68. See also, John
Creedy, ‘Personal Income Tax Structure: Theory and Policy’ in Iris Claus, Norman Gemmell, Michelle Harding
and David White (eds), *Tax Reform in Open Economies: International and Country Perspectives* (Edward Elgar
Economic Review 103. See also, Eric Toder and Kim Rueben, ‘Should We Eliminate Taxation of Capital Income?’
in Aaron, *supra* note 23, 89 at 90-91
33 Mirrlees (2011), *supra* note 18, 39-44
34 Creedy (2010), *supra* note 32, 141-42 discusses the application of this rule of thumb to the New Zealand tax
system. The New Zealand government tax policy work programme for 2015-16 is divided into three broad
areas, one of which is ‘further improvements and enhancements to tax and social policy within the broad base
35 OECD, *Choosing a Broad Base-Low Rate Approach to Taxation, OECD Tax Policy Studies, No 19* (OECD
Publishing 2010) 15
between the taxation of personal savings and the company tax, for example, or between personal savings taxation and means testing under the transfer system.

Indeed, in some cases, national taxes and transfers are so disorganized it is kind to call them a ‘system’. In the New Zealand Tax Working Group, for example, ‘coherence’ was one of the six principles of a good tax system that we used to assess the medium-term options for New Zealand tax reform.36 So central was this point to the conclusions of the Mirrlees Review of the United Kingdom tax system that the authors incorporated it at the beginning of their report title. They called their report Tax by Design: the Mirrlees Review. This emphasized both the problems they saw arising from the piecemeal approach taken to tax and transfer reform in the United Kingdom over more than 30 years and the need for systematic thinking in future. But, most importantly, the Mirrlees Review editors wanted to highlight that the review was using the methodology of optimal tax theory to achieve the best outcome for the whole tax and transfer system taking into account the constraints government was facing.37

Broader national public policy factors and theory in tax reform

Thirdly, we should recognize that national tax and transfer systems, including the rules for taxing personal capital income, often take into account broader national public policy factors and theory. This is not always made as explicit as it was in the Henry Review of the Australian tax and transfer system. The chair of that review, Ken Henry, has written that the review endorsed the design principles of equity, efficiency and simplicity; and added the principles of sustainability and policy consistency’ but it ‘did not focus on optimal tax system design, based on those principles. Instead, we positioned the tax and transfer system in a broader public policy context. We tried to think about how Australia’s tax and transfer system could best meet the nation’s opportunities and challenges over the next 40 years.38

The six broader public policy factors that the Henry Review focused on were:

- ‘deepening international integration together with a re-emergence of China and India;
- frequent and rapid technological advances;
- an ageing population;
- stronger growth and increasing cultural diversity of the population;
- deepening stresses between human activities and wider ecosystems; and
- pressures affecting housing affordability and urban amenity.’39

Clearly, the list of broader public policy factors to be taken into account, their relative importance and their relevance for taxing personal capital income and gains will differ in each of the six countries studied in this working paper: Italy, the Netherlands and the United Kingdom, which are three of the 28 members of the European Union; South Africa in Africa;

36 ‘Tax policy changes should be made with reference to a long-term strategy and framework that recognises the coherence of the overall tax system is vital.’ New Zealand, A Tax System for New Zealand’s Future, Report of the Victoria University of Wellington Tax Working Group (Centre for Accounting, Governance and Taxation Research 2010) 9, and see 13-16 also <http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/report> accessed 10 March 2015
37 Mirrlees (2011), supra note 18, 35-39
38 Ken Henry, ‘Tax Reform: Opportunities and Challenges’ in Chris Evans, supra note 17, 3
39 Ken Henry, supra note 38, 3
and, Australia and New Zealand in the Southwest Pacific. If one takes just two of these questions and thinks about them in relation to contrasting pairs of countries, it quickly becomes clear how important these broader public policy factors are. With whom is a country such as the Netherlands in Europe or New Zealand in the Pacific likely to be integrating in the next 40 years and how are their integration partners likely to tax personal capital income and gains in future? How is the population profile of a country likely to change over the next 40 years and what impact will the different rates of ageing in Italy and South Africa, for example, have on their respective personal capital tax bases?

Economic theory and influencing the public climate of opinion

Finally, ideas for improving the taxation of personal capital income, including capital gains, are important but so are communicating them to the public and then testing which ones make sense to the public. The basic concepts in these two theories are present in the public debate, often in colloquial terms: ‘a buck is a buck is a buck’ as the Carter Commission advocacy of the comprehensive income tax concept for Canada has sometimes been described; or, ‘no double taxation of saving’, which expresses the view of one stream of optimal income tax research that concludes the optimal tax rate on capital income in the long run is zero, near zero or negative.

John Kay, a former director of the Institute for Fiscal Studies (IFS) in the United Kingdom, has argued that ‘policy ideas are drawn from a climate determined by popular opinion, journalism and informed practitioners, and, in the long run, it is scholarship effectively communicated which is the primary influence on that climate.’ It is worth noting that the IFS, which set up and organized both the Meade and Mirrlees reviews of the United Kingdom tax system, ‘came into existence because four professional people from the world of finance … were appalled by the way in which the 1965 Finance Act, which introduced capital gains tax [into the United Kingdom], reached the Statute Book’. One of the three

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40 See Anthony F Sheppard, ‘Capital Gains: Twenty Years Later a Buck is Still Not a Buck’ in Neil Brooks (ed), The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later (Carswell 1988) 83. At the time, John Head questioned the popular acceptance of this idea: ‘Like Simons and his followers, the Commission probably greatly overrates the equity appeal of the net accretions base. Many people simply do not agree that items like wages, interest, dividends, capital gains and bequests and gifts all have the same taxable capacity per dollar.’ John G Head, ‘Henry Simons Regained: Report of the Canadian Royal Commission on Taxation’ (1970) Finanzarchiv 197 at 207 (emphasis in original)


43 JA Kay, supra note 28, 21

founding objectives of the IFS was ‘to alter the climate of opinion within which changes to
the British tax system were considered’.45

Altering the climate of public opinion in a country, however, is not always an easy thing to
do. In the United States, for example, Auerbach has noted ‘we have moved quite far from
thinking it natural that capital and labor income should be taxed according to the same
schedule, even if this movement is not yet fully reflected in public U.S. discourse, which, in
spite of the existence of favorable tax rates on dividends and capital gains, still largely
adopts the view that “income is income,” especially when contemplating the low average
income tax rates paid by high-income individuals’.46 We now turn to consider this Haig-
Simons comprehensive income concept of treating capital and labour income the same,
which continues to resonate with members of the public in many countries.

The comprehensive income tax concept and optimal tax theory

This section outlines the historical development of the comprehensive income concept and
optimal tax theory and examines their role in relation to several key issues for personal
capital gains taxation. Finally, we note the use of these two theories in two tax policy
reports published by the OECD in 2006 and a tax policy report published in 2010.

The comprehensive income tax concept

Through most of the 19th century, the concept of income that classic economists considered
was a viable source of taxation was narrow: ‘rent and income used for luxury
consumption’.47 The idea that the best measure of ‘equity’ and ‘ability to pay’ was
comprehensive income tax emerged near the end of the 19th century, especially in Germany
through the work of the legal scholar, Georg von Schanz.48 His idea of accretion was further
developed in the 20th century by two American economists, Robert Haig 49 and Henry
Simons.50 As a consequence, the theory is often eponymously called the Schanz-Haig-Simons
definition, or just the Haig-Simons definition, of income.

It is Henry Simons’ expression of the comprehensive income idea that has been most
frequently cited over the last 70 years. The task that Simons set himself was to devise a
‘quantitative and objective’ definition of income that was measurable and that reduced

speech in November that year announcing his intentions to make far-reaching tax changes in his next Budget,
including a capital gains tax and a corporation tax. ... The same half-baked proposals were rehashed in the
Budget Speech, and the Finance Bill, when published, read as if the draftsman had simply been given the
Callaghan speech and told to turn it into legislation.’
45 Bill Robinson, supra note 44, 3
47 Richard Musgrave, supra note 41, 1, 22
48 Georg von Schanz, “Der Einkommensbegriff und die Einkommensteuergesetze” (1896), 13 Finanzarchiv 1
49 Robert M Haig, ‘The Concept of Income—Economic and Legal Aspects’ in Robert M Haig (ed), The Federal
Income Tax (Columbia University Press 1921) 1
50 Henry Simons, Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy (University of
Chicago Press 1938)
arbitrary distinctions to a minimum. He acknowledged that it was not possible ‘to delimit the concept precisely in every direction.’ He hoped, however, that it would be a tool of analysis that was ‘useful, if crude’.\textsuperscript{51}

Gain is the central concept, as Simons makes clear in his definition:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The \textit{sine qua non} of income is gain, as courts have recognized in their more lucid moments - and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.\textsuperscript{52}

Among other things, this definition of income requires capital gains taxation that is:

- uniform (all assets in all types of economic activity should be taxed and no assets should be taxed at different rates of tax) rather than differential (some assets in some types of economic activity should not be taxed or different types of assets should be taxed at different rates of tax);
- taxing on accrual rather than on realization.

Each one of these major features has been challenged in theory or practice. First, consider the theoretical challenge to uniform taxation. The theory of second best\textsuperscript{53} essentially argues that in a distorted economy, policy makers should not apply a ‘first best’ rule, such as the comprehensive income tax concept, to remove each tax distortion one-by-one without thinking about other existing distortions and the wider ramifications for the tax system and the economy.\textsuperscript{54} Take taxing owner-occupied housing, for example. If administrative and compliance costs involved in measuring imputed rental income were the main problem, a second best approach might be to deny mortgage interest relief and use property taxes rather than taxing owner-occupied housing under the personal income tax.\textsuperscript{55}

\textsuperscript{51} Simons, \textit{supra} note 50, 42-43  
\textsuperscript{52} Simons, \textit{supra} note 50, 50 (emphasis in the original)  
\textsuperscript{54} The man who has been remembered by John Simon as ‘the First Lord of American tax scholars’ argued in 1967 that the comprehensive tax definition of income was not a helpful guide to address the major substantial problems of income tax law and in certain circumstances its advocates ‘have given too little attention to the paradox of the “second best.”’ Boris Bittker, ‘A “Comprehensive Tax Base” as a Goal of Income Tax Reform’ (1967) 80(5) \textit{Harvard Law Review} 925, 983-84. John G Simon, ‘Let us Count the Ways: A Tribute to Boris Bittker’ (2005-2006) 115 \textit{Yale Law Journal} 751  
\textsuperscript{55} OECD, \textit{supra} note 35, 80, citing Christopher Heady, Åsa Johansson, Jens Arnold, Bert Brys
The second major feature of the Haig-Simons definition can be satisfied only by taxing the change in value of assets for each period of time on an accrual or accrual-equivalent basis. Taxing the change in value only when an asset is sold or deemed to be sold does not satisfy this definition. Notwithstanding the issues of lock-in\(^56\) and tax arbitrage\(^57\) exacerbated by financial innovation,\(^58\) most real-world capital gains tax regimes continue to apply the realisation principle. The problems caused by the realisation principle seem so evident to us today, yet the author of this accruals definition of comprehensive income could also write in his 1938 book: ‘Outright abandonment of the realization criterion would be utter folly; no workable scheme can require that taxpayers reappraise and report all their assets annually; and, while this procedure is implied by the underlying definition of income, it is quite unnecessary to effective application of that definition.’\(^59\) This inconsistency with his earlier definition is puzzling to us reading it in 2015. Then, one reads two lines lower: ‘Thus, they must follow the realisation criterion, but not so blindly and reverently as in the past.’\(^60\) Simons then proposes a deemed realisation on property that is gifted or bequeathed. This proposal was innovative at the time. One possibility is that Simons was trying to move the American climate of opinion on from realisation and towards accrual. It was a case of one step at a time. Further evolution in thinking about how to eliminate deferral advantages and lock-in under a realization-based system without taxing on accrual has occurred in the work of Vickrey,\(^61\) the Meade Committee,\(^62\) Auerbach and Bradford\(^63\) and others. Still other scholars have developed detailed accrual taxation proposals and an agenda for research that includes expanding the assets that are marked-to-market.\(^64\)

There is a third point to note about Simons’ definition of income that is of particular relevance in relation to capital gains taxation. This definition uses market prices and requires no adjustment for inflation. To the extent that gain is merely inflationary gain, however, it is not increasing a taxpayer’s ability to pay and should not be part of the tax base. Further, inflation affects the returns on different types of their assets differently, creating distortions and non-neutralities with respect to the choice of investment. As a

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\(^{56}\) For a discussion of the empirical evidence from the United States on the issue of lock-in and the suggestion that it might be less of a problem than is often thought, see Burman and White, supra note 16, 376-378


\(^{59}\) Simons, supra note 50, 207-208

\(^{60}\) Simons, supra note 50, 208


\(^{62}\) Meade, supra note 30, 133–135


consequence, modern tax policy makers tend to take this issue more seriously than Simons did, without being able to do much about it. Take the 1989 New Zealand consultative document proposing reform of the tax treatment of income from capital, for example. It suggested that the comprehensive indexation of capital income and expenditure appeared to be feasible and was worth further investigation. More than eighty pages of the document dealt with the inflation and indexation issues. These proposals were never implemented at the time and New Zealand officials have now come to a different conclusion. In 2012 they recommended to Ministers that indexing the tax base should not be pursued as a medium-term reform after weighing the costs and benefits of the exercise as best they could: including, the impact on savings, cost of capital, returns to residents, and costs for government and taxpayers, especially for SMEs.

Optimal tax theory

Optimal tax theory is part of the general theory of second best. It recognizes that governments are trying to raise revenue in an economy that is inevitably distorted (i.e., ‘second best’), as individual lump-sum taxation is not feasible to achieve a required distribution without causing distortion (i.e., ‘first-best’). In very broad terms, optimal tax theory uses economic analysis to convert equity, efficiency, and, to a much lesser degree, administrative costs, into a common measure of ‘social welfare’ in order to choose tax policy or a tax reform that ‘gives the highest level of social welfare’. These choices are constrained by the need for government to finance its expenditure by tax revenue and to take into account how individuals respond to taxes and transfers.

Seminal work by James Mirrlees and Peter Diamond on modern optimal tax theory was published in the early 1970s. In 1975, a conference on taxation theory was organized in Paris to introduce the subject of optimal taxation and to focus mainly on how it related to tax reform problems. One paper by Martin Feldstein acknowledged that, ‘all of the recent economic studies of practical tax reform have taken the Haig-Simons standard of optimal taxation as their guide’ but criticised it, either as a principle for de novo tax design or existing tax law reform, arguing that it was both inefficient and inequitable, viewed from the perspective of optimal tax theory or the theory of tax incidence.

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65 Caygill, supra note 15
67 Social welfare measures the well being of society in terms of the utilities of individuals (or households) and the distribution of those utilities. It measures the broader measure of utilities rather than real after-tax incomes. Take, for example, the measure of the cost of a tax increase. Allowing the disutility of work where a person responds to the tax increase by working longer hours to be added to the person’s lower real after-tax income arrives at an aggregate cost that is more complete. Christopher Heady, ‘Optimal Taxation as a Guide to Tax Policy’ (1993) 14(1) Fiscal Studies 15, 16-21
Through the 1970s and beyond, the optimal tax literature grew substantially as many more academic economists used the methodology for considering public finance issues. Recognition for the two fathers of modern optimal tax theory has included separate awards of the Nobel Memorial Prize in Economic Sciences in 1996 (Sir James Mirrlees) and 2010 (Peter Diamond).  

As a leading public finance scholar and econometrician reviewing the literature from 1970 to 2000 that is written in English has observed, the field of public economics research has been transformed. In Martin Feldstein’s view, it has become ‘more theoretically rigorous, more empirical, more focused on real policy issues …’. Advances in theory have resulted from the use of more sophisticated mathematics and the development of new general equilibrium models. Even larger advances have been made in empirical research as a result of ‘the availability of high speed computers, reliable econometric software, and large machine-readable data sets … plus the addition of sophisticated econometric techniques …’.

And the future? Even with all these advances, there are frustrations with the data available and the constraints on performing experiments. Ten years on from his assessment in 2000, Martin Feldstein and other eminent US researchers argue strongly for direct access to, and the ability to merge, administrative micro-data sets so that researchers can make more credible evaluations for public policy. A leading US public finance economist and tax policy expert has described the data available to US tax researchers as ‘grossly inadequate’ and set out a short and long term agenda to get better data from federal, state and local government, including asset and savings data useful for research on capital gains. But, on a more hopeful note, one of the fathers of modern optimal tax theory suspects that further advances in our understanding of the role of capital income taxation will be made by analysts bringing behavioural perspectives about people’s decision-making to issues such as ‘the intertemporal movement of the realization of income, both capital gains and labor income.’

Drawing on optimal tax theory, there are a huge number of capital income taxation studies and models with some public finance economists arguing that the lesson from the academic literature for policymakers is no taxation of capital income, significant taxation of capital income.

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71 Officially called the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel. ‘All prizes in economic sciences’ <http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/> accessed 10 March 2015


73 Martin Feldstein, supra note 72, 320-321


income, and various points in between. One of the fathers of modern optimal taxation has recently argued that he is concerned that too many economists take the findings of individual studies literally as a basis for policy thinking, rather than seeking inferences from multiple studies that consider multiple aspects of a policy question, along with using intuitions about aspects of policy that are not well addressed in any existing models. And of course empirical findings are needed as well. ... [C]ombining diverse insights in an intuitive way is not simple... .

In another article, Peter Diamond joins with Emmanuel Saez in discussing how best to get from basic optimal tax theory research to policy recommendations. Both had worked on the Mirrlees Review where the policy relevance of various lines of optimal tax literature was one of the major issues (see the discussion of the United Kingdom in the next section). They also disagreed with the methodology being used in some of the literature to draw policy lessons from optimal tax theory. Diamond and Saez suggested that the best path forward was for economic analysis to follow the Meade Report approach. It should first examine incentives and economic efficiency, distributional effects, international aspects, simplicity and costs of administration and compliance, flexibility and stability, and transitional problems. After examining each of these issues, they should then combine the insights into a policy recommendation. It seems to me that, ideally, undertaking economic research within this framework would involve input from other disciplines and people working in tax practice and business, for example, particularly about the last five issues: international aspects, simplicity and costs of administration and compliance, flexibility and stability, and transitional problems.

There is much to celebrate in the insights gained from more than forty years of increasingly rich theoretical and empirical literature that focuses more on real issues but there is also a downside for non-economists, whether they are tax specialists from other disciplines or non-tax specialists, including politicians and the public. Much of the public finance literature from the late 1960s has required a considerably higher level of technical economic and mathematical skills to read and understand it. The gap between those who have the necessary expertise to understand the literature, identify and assess implicit assumptions

77 See Banks and Diamond, supra note 29, 548 for a survey of the literature. See also, the debate in the Journal of Economic Perspectives about whether it is possible to draw from the optimal tax literature a policy conclusion that capital income should be taxed. Mankiw and others have argued optimal tax theory suggested a general lesson that capital income ought to be untaxed at least in expectation. Gregory N Mankiw, Matthew C Weinzierl, and Danny Yagan, ‘Optimal Taxation in Theory and Practice’ (2009) 23(4) Journal of Economic Perspectives 147. Peter Diamond and Emmanuel Saez disagree and make a ‘qualitative recommendation’ that ‘capital income should be subject to significant taxation’. They explain, for example, why, in their view, the assumptions in infinite-life models, requiring individuals ‘to make consistent rational decisions about savings behaviour across very long horizons’ – not just across their lifetimes but across dynasties – means that the Chamley and Judd models are so far from reality that they have some but limited policy relevance. Peter Diamond and Emmanuel Saez, ‘The Case for a Progressive Tax: From Basic Research to Policy Recommendations’ (2011) 25(4) Journal of Economic Perspectives 165, at 177-83 and 185

78 Peter Diamond, ‘Economic Theory and Tax and Pension Policies’ (2011) 87 Economic Record (Special Issue) 2 at 4-5

79 Diamond and Saez, supra note 77, 184
and hold in tension the different messages from this literature for policy purposes, and those who do not, has grown very large. Inspired by Meade, as we noted New Zealand tax policymakers were in the late 1970s, Diamond and Saez have proposed a path forward for optimal tax research to formulate policy recommendations. Input from other disciplines to these economic research efforts following this methodology would greatly enhance them.

**OECD**

Finally in this section, we consider the continuing use of the comprehensive income tax concept and optimal tax theory by the OECD in relation to personal capital income and gains taxation in three reports: the 2006 report on fundamental reform of personal income tax; the 2006 report on taxation of capital gains of individuals; and the 2010 report on choosing a broad base-low rate approach to taxation. The OECD used both theories in each of these reports but the emphasis changes according to the issue under discussion.

The first OECD report analysed personal income tax trends in OECD countries that have mostly reduced rates and broadened bases through introducing semi-dual income taxation of personal capital income or flat tax reforms. This report identified six possible types of personal income tax systems, using the Schanz-Haig-Simons definition of comprehensive income to define one type (the comprehensive income tax system) and the Scandinavian development of dual income tax systems in the early 1990s to define the other. The comprehensive income tax system combines capital, labour and other income and taxes the net income at progressive rates. The dual income tax system taxes all net income at a proportional tax rate and labour and pension income at rates that are higher and progressive.

In practice, the report noted no OECD country fully implements either of these two ‘pure’ types. Consequently, most real-world personal income tax systems in the OECD were categorised as either ‘semi-comprehensive’ (mainly taxing on realisation and not taxing imputed income from owner-occupied housing, for example) or ‘semi-dual’ (again, not taxing imputed income from owner-occupied housing, for example). The discussion in the report indicates the difficulty of categorising OECD country tax systems. The classification results differ according to the factors taken into account. There are two key points for our purposes. First, the comprehensive income concept was explicitly used and optimal tax

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80 OECD, *Fundamental Reform of Personal Income Tax: OECD Tax Policy Studies No 13* (OECD 2006) 3. Two of the other types of personal income tax systems were the flat tax system and expenditure tax system.

81 OECD, *supra* note 80, 71-85. For an early discussion about the link between dual income taxation systems and the theory of optimal taxation in terms of economic efficiency in both closed and small open economies, see Peter Birch Sørensen, ‘From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms In the Nordic Countries’ (1994) 1 *International Tax and Public Finance* 57, 69-70. In the same article, Sørensen makes an interesting second-best optimal argument about the link with the comprehensive income concept. He argues that greater taxation of high labour income in a dual income tax system may get closer to the ‘philosophy’ of the Haig-Simons definition, in light of the impossibility of including changes in human capital in the tax base (pages 64-67, 76). More recently, Robin Boadway has reviewed the literature and the growing support for some taxation of capital income, which he considers tends to support a schedular approach to taxing capital income and earnings at different rates, such as the dual income tax system does. Robin Boadway, *From Optimal Tax Theory to Tax Policy: Retrospective and Prospective Views* (*Munich Lectures in Economics*) (MIT Press, 2012) 136.

82 OECD, *supra* note 80, 72
considerations were taken into account in categorising most OECD personal income tax systems using any measure.\textsuperscript{83} Second, the conclusion of the report is that many OECD countries have been experimenting with semi-dual personal income tax systems as genuine comprehensive personal income tax systems seem ‘to be administratively extremely costly and politically infeasible’ and unsustainable given increasingly mobile tax bases.\textsuperscript{84}

The second OECD report released the findings of a project on policy considerations and alternative design features for the taxation of capital gains of individuals.\textsuperscript{85} The project had reviewed the public finance literature, the responses from 20 OECD countries to a questionnaire and descriptive material on personal capital gains tax rules in all OECD countries. The report began by reflecting on the New Zealand government response. New Zealand is one of the few OECD member countries not comprehensively taxing capital gains and the New Zealand response to the questionnaire does not seem to have favoured doing so in the future. Yet, noted the OECD, even New Zealand started its analysis with the comprehensive Haig-Simons definition of income. The OECD report followed the New Zealand lead and used the comprehensive income concept here and through the report. It admitted that doing so is ‘somewhat arbitrary, given that no country strictly adheres to fully comprehensive treatment.’\textsuperscript{86} For the purposes of the report, a tax system was classified as providing comprehensive taxation of capital gains of individuals if it included ‘gains/losses on equity shares of public and private companies held by portfolio investors, including gains/losses on shares held for more than one year.’\textsuperscript{87}

The report then analysed five central considerations for policy-makers deciding whether and how to tax personal capital gains: tax revenue; efficiency considerations including ‘lock-in’ effects; horizontal and vertical equity; the encouragement of savings and investment; and taxpayer compliance and tax administration costs.\textsuperscript{88} The report also considered the possible effects of capital gains taxation on risk-taking by individuals (portfolio allocation between safe and risky assets), and possible effects on the cost of capital and corporate financial policy.\textsuperscript{89} It would seem that when the issue is conceptualised as one of personal ‘capital gains’ rather than the broader topic of personal ‘capital income’, the comprehensive income concept still remains influential when undertaking policy analysis.

The third OECD report was written in 2010 and considered whether it was best for countries to raise taxes by broadening tax bases or raising tax rates as part of fiscal consolidation. It is more focused on the broader topic of personal ‘capital income’ than personal ‘capital gains’. In chapter one the economic analysis of revenue-neutral reforms that broaden the personal

\textsuperscript{83} OECD, \textit{supra} note 80, 73-74  
\textsuperscript{84} OECD, \textit{supra} note 80, 134  
\textsuperscript{86} OECD, \textit{supra} note 85, 30  
\textsuperscript{87} OECD, \textit{supra} note 85, 30  
\textsuperscript{88} OECD, \textit{supra} note 85, 31-69  
\textsuperscript{89} OECD, \textit{supra} note 85, 71-103, 127-167
income tax and capital income tax bases and lower rates to improve the tax system began and ended with optimal tax theory.\textsuperscript{90} There is extensive discussion of optimal tax theory and considerations and no reference to the comprehensive income concept in considering the arguments for differential or uniform taxation. In the next chapter, summarising the OECD experience in tax expenditure reporting, however, there is considerable discussion of the comprehensive income concept. One reason for this is that a group of OECD member countries (Australia, Canada, Finland, Sweden, Switzerland and the USA) continues to measure tax expenditures in relation to a modified version of comprehensive income tax, sometimes in conjunction with other benchmarks.\textsuperscript{91} In chapter three, the evaluation of tax provisions included the treatment of housing. There were two benchmarks chosen: comprehensive personal income tax and expenditure tax.

As noted at the outset, the OECD used both the comprehensive income concept and optimal tax theory in each of these three tax policy reports but the relative use of the two theories changed according to the issue under discussion. When the issue was conceptualised as one of personal ‘capital gains’ rather than personal ‘capital income’, the comprehensive income concept was particularly influential in the policy analysis.

\textbf{Public tax reviews and official reports}

We will now examine the use of comprehensive income and optimal tax theory in the analysis by selected public tax reviews and official reports on personal capital gain reform in six countries: the South African introduction of a comprehensive nominal capital gains tax on a realization basis (1994-2001); the short-lived Italian experiment implementing Haig-Simons accruals and accruals-equivalent regimes in a semi-dual income tax setting (1997-2004); the Dutch introduction of a presumed return method in a semi-dual income tax setting (1997-2001); the New Zealand consideration of comprehensive capital gains tax and presumed return method proposals in a semi-comprehensive income tax setting (2001-2012); an Australian proposal to refine Australia’s hybrid personal income tax base including a 40% savings income discount for capital gains and losses held as non-business investments (2008-2009); and, the United Kingdom Mirrlees Review use of optimal tax theory and a rule of thumb in thinking about the personal tax base and the taxation of capital (2006-2011).

\textbf{South Africa 1994-2001}

We first visit Pretoria. In 1994 South Africa held its first general election with universal adult suffrage. The African National Congress won a clear majority and formed a government of national unity with the next two largest parties in the National Assembly. One of the first acts of the National Assembly was to elect Nelson Mandela as President. Less than two months later, the South African Government appointed a commission headed by a corporate lawyer, Michael Katz, to enquire into the South African tax system. The tax system

\textsuperscript{90} OECD, \textit{supra} note 35, 14-15, 19-26

\textsuperscript{91} OECD, \textit{supra} note 35, 51-53
faced huge economic, political, institutional and legal challenges, including: one of the highest rates of income inequality in the world resulting in popular pressure on the new government to redistribute or even expropriate; a rapid and critical loss of experienced revenue department staff; and, constitutional problems with parts of the income tax.  

The Katz Commission met between 1994 and 1999 and issued nine interim reports. Its third interim report in 1995 considered the advantages and disadvantages of a capital gains tax for South Africa. Chapter six of the Katz Commission’s third interim report concerned capital gains tax. In the very first paragraph, its analysis of the issues began with the Haig-Simons definition of income. Several paragraphs later, it included a lengthy extract from the Canadian Carter Commission report setting out the main arguments for adopting the comprehensive income tax approach. It then discussed key issues in the design of a capital gains tax, setting out eight arguments in favour and eleven arguments against the introduction of a capital gains tax. It did not make a recommendation concerning capital gains tax in the 1995 report as it considered the South African revenue service would not have been able to administer such a highly complex tax when it was facing such staffing problems. It is clear, however, what its view was. It pointedly noted that it should not be inferred that ‘but for the lack of administrative capacity the Commission would have been in favour of a recommendation to introduce a capital gains tax in South Africa. Its low potential revenue yield reinforces this conclusion.

Following the decision of the South African Government to introduce a comprehensive capital gains tax, the South African National Treasury prepared a briefing on capital gains taxation for a parliamentary committee. The briefing is 37 pages long with half of it dealing with the inflation and indexation and the other half with all other capital gains tax issues. Near the front, it asserted that ‘many jurisdictions accept the soundness of the ‘comprehensive income’ concept as the ideal tax base’. It also used the comprehensive income concept as the starting point for its analysis elsewhere. Devoting half of their parliamentary briefing to inflation and indexation indicates how seriously officials viewed this issue. In the end, however, they proposed a comprehensive nominal tax rather than a comprehensive real tax. There were many reasons for this recommendation but perhaps the most important was ‘at moderate levels of inflation and defensible real rates of return, the

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94 South Africa, supra note 93, paragraph 6.1.1
95 South Africa, supra note 93, paragraphs 6.2.2-6.2.4
96 South Africa, supra note 93, paragraphs 6.6 and 6.7
97 South Africa, supra note 93, paragraph 6.6.2
99 South Africa, supra note 98, 4, 10, 18
low inclusion rates proposed and the deferral benefits arising because the tax is levied on a realisation basis more than adequately compensate for the effects of inflation.'\textsuperscript{100} A major problem, of course, is that this ‘compensation’ applies very unevenly across investments and across time.

In terms of economic theory, the South African capital gains tax is a straight-forward capital gains and Haig-Simons story, albeit one that uses the realisation rather than the accruals principle. At each stage of consideration, it was the Haig-Simons definition of income that was the starting point for analysis of the capital gains issues. It is also common to see references to the Canadian Carter Commission report of 1966, which first sought to operationalize the Haig-Simons definition of income throughout a national tax system.

A final point to note is that South Africa seems to provide a familiar warning about the legal complexity of conventional, realization-based capital gains taxation. The South African Revenue Service (SARS) publishes online a ‘Comprehensive Guide to Capital Gains Tax’. The length of the guide has two main sources. First, parliamentary explanatory memoranda supporting the original capital gains tax legislation and all amendments provide the foundation for the guide. This material has been revised and ‘many more explanations, examples and illustrations’ have been added. Secondly, ‘much of the additional material was inspired by the many emails and writing queries submitted by the public’.\textsuperscript{101}

There have been five issues of the Guide. A possible proxy for legal complexity of a conventional, realization-based capital gains tax is the growing length of the issues of this guide. As it is issued by SARS online rather than in hard copy, there are no publishing cost constraints that muddy the waters for using this as a proxy for increasing complexity. It appears to have had the same author in charge of writing it throughout: Duncan S McAllister. The first draft version of the guide I can locate online is a March 2005 draft version released for comment before a final version was going to be published later that year. The March 2005 draft issue was 458 pages long.\textsuperscript{102} The December 2014 issue is a massive 814 pages.\textsuperscript{103}

\textbf{Italy 1997-2004}

Our next stop is Rome. In the 1980s the composition of Italian household savings portfolios changed dramatically. Bank deposits constituted nearly 75\% of household assets in 1980 and just 49\% in 1990. The share of total Italian household portfolios made up of mutual funds and discretionary accounts managed by financial intermediaries more than doubled in the same period to 22\%. In 1990, a tax on capital gains arising from shares was introduced

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\textsuperscript{100} South Africa, \textit{supra} note 98, 33
\textsuperscript{103} South African Revenue Service, \textit{supra} note 101
\end{flushright}
and then quickly repealed for many transactions. Capital controls were dismantled and financial markets became increasingly sophisticated. Pressure grew within Italy for reform of the tax system, which was perceived as ‘complex, inefficient, and inequitable’. External pressure was also building as the Italian capital market continued to integrate with others, particularly in the European Union.

The finance minister in the centre-left governments from 1996 to 2000 was a professor of public finance who was ‘a staunch supporter of the Haig–Simons definition of income’. While in opposition, he had prepared proposals to reform radically the personal taxation of capital income amongst other things. Professor Visco’s 1998 reforms implemented more uniform tax rates, redefined the concept of taxable income and subjected much more capital gain to taxation through three regimes: an accruals and two accruals-equivalent capital gains tax regimes. The reforms did not implement a truly comprehensive income tax as capital income and capital gains were taxed at very low proportional rates, not at the same rates as labour income. Another key feature of the reforms was that financial intermediaries were used to lower the compliance costs of these accruals reforms within this proportional tax system.

First, the 1998 reforms included two accruals-equivalent capital gains tax regimes. They applied a realization method with an adjustment to approximate the result from the accruals regime, drawing on earlier proposals made by Nobel Laureate economist William Vickrey in 1939 and the UK Meade Committee in 1978. There were three methods to create equivalence between taxation on accrual and realisation. They required the building of a sophisticated database to enable precise calculations of accrued capital gains at year end. Their complexity led to extended debate. As a result, their introduction was delayed several years until January 2001. They were then applied retrospectively to gains accruing from 1 July 1998. The constitutionality of the equalising tax regime was challenged in the courts, leading to a suspension of the regime in August 2001. Shortly after the election of a new centre-right government, the regime was abolished in September 2001. After critical

104 This account draws on Julian Alworth, Giampaolo Arachi, Rony Hamau, ‘What’s Come to Perfection Perishes: Adjusting Capital Gains Taxation in Italy’ (2003) 56(1) National Tax Journal 197. The Italian personal capital income reforms are put into the broader context of the business tax reforms in Massimo Bordignon, Silvia Giannini, Paolo Panteghini ‘Reforming Business Taxation: Lessons from Italy?’ (2001) 8(2) International Tax and Public Finance 191
105 Alworth, supra note 104, 203 footnote 6
106 I am leaving to one side the tax treatment of ‘qualified holdings’ of capital gains by individuals. Alworth, supra note 104, 204
analysis of this innovative change and consideration of its revenue, distortionary and other effects, three distinguished Italian economists concluded,

> there exists a gap between the methods and concepts used by economists in analyzing issues like the “lock–in” effect and the methods and concepts that can be used in the political and legal arena for upholding ex–post adjustments of realized income. Even the more sophisticated adjustments such as those put forward by Auerbach (1991) are not immune from political pressures and “ex–post” equity considerations.”

This point about the gap between economic analysis, assumptions and equivalences and their acceptance by non-economists was alluded to earlier and is relevant in thinking about public acceptance of ex ante proposals for taxing personal capital income using higher rates of tax than the 1.2% Dutch presumptive return method does (see discussion of both the Netherlands and New Zealand below).

Second, the Italian accrual capital gains part of the 1998 reforms lasted a little longer but it too was eventually abandoned because of its ‘significant tax compliance and tax administration costs associated with its trial’. In 2004, a new realisation-based capital gains tax was introduced.

Italy had undertaken an elaborate experiment to move its tax system closer to the Haig-Simons accruals ideal by taxing personal capital gains annually using a combination of an accruals and accruals-equivalent tax regimes. The Italian radical experiment had failed. It had the advantages of tax being imposed at very low flat rates and using financial intermediaries to lower its compliance costs but it also had considerable implementation problems that undermined its chances of success.

**Netherlands 1997-2001**

We now move north to The Hague. Like Italy, the Netherlands is part of the European Union. In the 1990s, capital markets in the European Union were continuing to integrate but national capital income tax systems were not converging and had become less neutral. Tax competition between countries, together with tax planning and tax evasion, were putting pressure on European capital income taxes. The Dutch income tax system itself distorted household savings, including through concessionary treatment of capital gains.

In the 1990s, an academic debate took place in the Netherlands about how to improve the

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109 See Warren, *supra* note 12 and Auerbach, *supra* note 46

110 OECD, *supra* note 85, 64

111 OECD, *supra* note 85, 60


effectiveness of capital taxation taking into account the move to lower, flat rates of tax on capital income in the Scandinavian dual income tax reforms.\footnote{Henk Vording and Allard O Lubbers, ‘The Netherlands Presumptive Income Tax on Portfolio Investment: Background, Aims and Effects’ (2006) 60 (1) \textit{Bulletin for International Taxation} 327, 328-30}

In 1997, the Dutch government issued a white paper called ‘The Tax System for the 21\textsuperscript{st} Century’. It was not a public tax review but a government paper that is said to have been highly influenced by a politician, who argued ‘his proposal for portfolio investment taxation would in fact increase tax revenues in that area, trading some symbolic progressivity for greater effectiveness.’\footnote{Tweede Kamer der Staten-Generaal, ‘Belastingen in de 21e eeuw een verkenning’, which can be translated into English as ‘The Tax System for the 21\textsuperscript{st} Century’, Second Chamber of Parliament, 1997-98, 25 810, No 2} The white paper had relatively little to say about capital gains tax, largely dismissing it as an option for a small open economy such as the Netherlands seeking to attract capital and criticising the deficiencies of real-world capital gains taxes that use the realisation principle.\footnote{Tweede Kamer der Staten-Generaal, supra note 116, see paragraphs 6.4.2 and 6.8} Apparently, the Dutch cabinet arguments for rejecting capital gains taxation included its harmful effect on risk taking and the difficulty of making inflation adjustments.\footnote{Sijbren Cnossen and Lans Bovenberg, ‘The Dutch Presumptive Capital Income Tax: Find Failure?’ Sijbren Cnossen and Hans-Werner Sinn (eds), \textit{Public Finance and Public Policy in the New Century} (MIT Press 2003) 241, 253}

In 2001, a new Income Tax Act was passed to replace the 1964 act, implementing a ‘box’ system for taxing different types of income. Box 3 taxed income from portfolio investment and saving, including, for instance, shares, bonds, savings accounts and real estate other than a taxpayer’s main home. The previous system left capital gains untaxed so favouring forms of savings that produced most of their return in the form of capital gains only. The new system in Box 3 applied a presumptive rate of 4% to net selected portfolio investments and savings held by individuals and taxed that amount at a rate of 30% (in effect, a tax rate of 1.2%). It has been suggested in an OECD working paper that the 4% presumptive rate ‘is designed to approximate the risk-free rate of return.’\footnote{Harding, supra note 4, 14} As a consequence, it does not tax supernormal or unexpected returns, as a traditional capital gains tax might do. Perhaps as a result of criticism by tax academics who favoured capital gains taxation, it was agreed that there would be a review in 2005, especially concerning the operation of Box 3. The evaluation was very positive about the performance of the Box 3 system but many of its findings were based on estimates.\footnote{Vording, supra note 115, 330, 332-33}

The Box 3 system has been criticised by some academics, including two prominent Dutch academic economists. Commencing from what they admit is largely a value judgement, they assumed ability to pay is best measured by income and the comprehensive income concept\footnote{Cnossen, supra note 118, 259, footnote 7} and compared the new Netherlands presumptive capital income tax with three other options: a realisation-based capital gains tax; retrospective capital gains tax; and, mark-to-market tax. After evaluating these options, they suggested the best option would be: accrual capital gains taxation for financial products and realisation capital gains tax on
real estate with an interest charge to reduce lock-in. They also advocated levying a single flat rate of tax on all actual capital income and, if that did not produce enough revenue, a dual income tax system with a moderate flat rate of tax on actual capital income and higher rates of tax on labour income.  

In summary, this Dutch innovative reform rejected the concept of capital gains and Haig-Simons theory. The reform broadened the Dutch personal savings and investment tax base but taxed the base at a low rate using a presumptive tax method: effectively, through a net wealth tax of 1.2%. As we discussed earlier, a second-best optimal tax argument has been made for a small, open economy broadening its capital income tax base and imposing a low flat tax on all capital income but the Dutch income tax (wealth tax?) initiative has been criticised by some Dutch academics from a comprehensive income tax perspective.  

**New Zealand 2001-2012**

We now take a long trip down to the southwest Pacific to Wellington. As noted earlier, tax policy analysis in New Zealand had become much more systematic and principles-based in the late 1970s. Much New Zealand income tax reform from the mid to late 1980s was designed to tax capital income in a more neutral manner by implementing a comprehensive nominal income tax. By 1989, the New Zealand income tax system was, in the view of the OECD, ‘probably the least distorting in the OECD.’

In 1989, the government proposed to review remaining exemptions of capital income from comprehensive income tax and to examine the feasibility of comprehensively indexing capital income and expenditure from the impact of inflation. The trade-off in this package, however, was not broadly acceptable and the proposals were never implemented.

In 2001, a panel was set up by the New Zealand Government to review the tax system. The panel did not support taxing capital gains more comprehensively using ‘a traditional capital gains tax’ as it considered the costs were likely to outweigh the benefits. Instead, it proposed ‘more fundamental reform’ of a statutory risk-free return method (RFRM) of taxation for the taxation of specified assets, specified entities, or a mixed regime that applied both to specified entities and shares in them. The formula for RFRM is ‘(net asset value at the start of the year) x (statutory risk-free real rate of return) x (the tax rate of the investor).’

Some but not all of the optimal tax theory and rationale supporting the proposal can be found in the report. The RFRM seems to rely on literature arguing that *ex post* taxes, such

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122 Cnossen, *supra* note 118, 258  
124 Caygill, *supra* note 15, i-ii  
126 McLeod, *supra* note 10, 121, 125 and 129  
127 McLeod, *supra* note 125, 31-42, 175-185
as capital gains taxes, where the amount an individual pays depends on how their uncertain investments performs, is equivalent to an *ex ante* tax, such as RFRM, that produces certain revenue for the government. The argument depends on a number of assumptions including the adjustments individuals make to their portfolios in response to taxes and how governments respond to uncertain revenue streams.

Auerbach has reviewed the argument that taxing excess returns to risk taking is of little economic consequence. He concluded that ‘it is an empirical question how relevant the result is’ as it involves ‘many assumptions that do not hold exactly.’ Nonetheless, the framework was ‘useful for understanding and analysing different policies and proposals’ so long as attention was paid to ‘violations of assumptions and their implications’.

Alan Auerbach was also the external consultant for the New Zealand Tax Review 2001 and he commented that the McLeod Committee’s RFRM proposal in relation to domestic assets, ‘would move the tax system toward a more neutral position with respect to asset choice. But a well-designed capital gains tax is a serious alternative that in some cases would be no more difficult to implement than the RFRM and deserves more serious consideration.’ The RFRM proposals of the McLeod Committee were not implemented at the time but they were considered again by the next public tax review in 2009. A well-designed capital gains tax has not been put in place either.

The Victoria University of Wellington Tax Working Group (TWG) was an independent group formed with the support of the Ministers of Finance and Revenue ‘to identify major issues that Ministers will need to consider in reviewing medium-term tax policy and to better inform public debate on tax’. A background paper on the taxation of capital gains prepared by the Treasury and Inland Revenue Department for the TWG in September 2009 frequently referred to the comprehensive income concept of economic income. And, in chapter two, which is about whether capital gains should be taxed, the analysis in the document began from the Haig-Simons definition of economic income. After all of its

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129 Kaplow, supra note 128, 796
130 Kaplow, supra note 128
131 Alan J Auerbach, ‘Notes on Taxation and Risk Taking’ (2009) 24(1) Australian Tax Forum 31, 39. He examines US data in relation to the key assumptions necessary for the model to work as they cannot all hold: the assumption of symmetric taxation; the assumption of complete market participation; and the assumption that ‘private markets must pool risk efficiently’ and ‘government spending must not be affected by the riskiness of its revenue stream’.
132 Auerbach, supra note 131, 39
133 Auerbach, supra note 10, 14
134 Victoria University of Wellington Tax Working Group, supra note 36, 5
135 New Zealand Officials, ‘The Taxation of Capital Gains’ September 2009, 1, 2, 4, 8, 9, 33, 41 available at <http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/session-three> accessed 10 March 2015. In a paper commissioned by the New Zealand Treasury for consideration by the Victoria University of Wellington Tax Working Group, Chen and Mintz recommended that, with a company income tax rate below the top
deliberations, the final report of the tax working group indicated that members were divided in their opinion on this issue. It reported:

‘While some view [a comprehensive capital gains tax] as a viable option for base-broadening, most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT. The other approach to base broadening is to identify gaps in the current system where income, in the broadest sense, is being derived and systematically under-taxed (such as returns from residential rental properties) and apply a more targeted approach. The majority of the TWG support detailed consideration of taxing returns from capital invested in residential rental properties on the basis of a deemed notional return calculated using a risk-free rate.’

Finally, there is a 2012 report by officials to New Zealand Ministers on the taxation of savings and investment income that reported the different views of the Treasury and Inland Revenue officials on capital gains tax reform. The report drew on: standard first principles analysis; a computable general equilibrium model developed by US academics and modified by officials, which allowed them to think about the broader impact of tax reforms on the economy; a model to help them think about how a capital gains tax might influence housing investment in New Zealand; and consideration of the likely impacts on equity, the integrity of the tax system, complexity, compliance and administration costs. Both the Treasury and Inland Revenue Department agreed that a capital gains tax was consistent with the broad base-low rate rule of thumb adopted by the New Zealand government. Drawing insights from the capital gains modelling, Treasury’s view was that ‘a capital gains tax should improve allocative efficiency on a first principles basis’ but much depended on the design of the tax. Inland Revenue agreed with Treasury on the design point but concluded that ‘the practical disadvantages of a capital gains tax are likely to outweigh its advantages.’

To conclude, New Zealand presents us with a kaleidoscope, both in terms of current law and reform proposals. Existing law uses both the legal and economic conceptions of ‘capital gains’ in relation to specified assets and the economic conception of ‘return to capital’ in taxing foreign portfolio share investment. It excludes some gains from income. It taxes some gains on realisation and others on accrual. It taxes foreign portfolio share investment using a presumed rate of return method. This mix of hybrid taxation and no taxation is difficult to justify on efficiency, equity, integrity, complexity, compliance and administration personal marginal tax rate, ‘New Zealand should also consider broadening the capital gains tax base so that gains are taxed at the same rate as dividends. This will not only reduce the incentive for taxpayers to convert income into capital gains but it would also ensure better integration of company and personal taxes.’ Duanjie Chen and Jack Mintz, ‘Capital Taxation in New Zealand: A Review from an International Perspective’, 37 available at <http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/twg-papers-index> accessed 10 March 2015

136 Victoria University of Wellington Tax Working Group, supra note 36, 11
137 New Zealand Officials, supra note 66
138 New Zealand Officials, supra note 66, 8
139 New Zealand Officials, supra note 66, 12
In analysing possible tax reform, both Haig-Simons' and optimal tax theory have been used. Finally, both the ‘broad-base low-rate’ and ‘neutrality’ rules of thumb continue to be major elements in analysing whether the New Zealand income tax should tax capital gains more comprehensively. In addition, the broader use of a presumptive return method, similar to that in operation in the Netherlands, has been proposed and debated in New Zealand.

**Australia 2008-2009**

Next, we make a short jump across the Tasman Sea to New Zealand’s nearest neighbour, Australia. In 1975, the Asprey Review, influenced by Henry Simons’ formulation of economic income, had concluded that there was ‘a very strong case’ in equity and ‘a case’ in efficiency for taxing capital gains. Although the Asprey Review made detailed recommendations on many capital gains tax design features (for example, taxation on realisation of gains arising after the introduction of the tax), it suggested that the government should publish a detailed proposal for analysis and debate before deciding to tax capital gains and introduce capital gains tax legislation. It was not until ten years later in 1985 that a comprehensive capital gains tax was introduced in Australia.

Two senior officials who worked on capital gains tax policy in 1985, Ken Henry and Greg Smith, were appointed the chair and a member of the five-person Henry Review in 2008. How would this panel react to developments in optimal tax theory and the uncertainties about the way forward in their final recommendations?

In a speech given shortly before the Review delivered its report, Ken Henry had said:

> [W]hile many in Australia continue to see comprehensive income tax as the ideal, seminal reviews into taxation around the world in the last three decades have largely … abandoned

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140 See Burman and White (2003) and (2009), supra note 16; Chen and Mintz, supra note 132. Further, in a lecture given in Wellington as the 2013 Robin Oliver Scholarship Visiting Lecturer in Tax Policy, Alan Auerbach noted that although there were many problems with capital gains tax there were also many problems caused by not having a comprehensive capital gains tax, for example by increasing the importance of getting closer alignment of individual and corporate tax rates. This issue was very prominent in the New Zealand Tax Working Group report and recommendations: Tax Working Group supra note 36, 10-11, 38-44. And, how might Auerbach reform a conventional capital gains tax while waiting for fundamental tax reform? In a short note on reforming the US capital gains tax, Auerbach proposes a package to make the US tax system more progressive and to reduce distortions caused by the current capital gains tax. First, as US capital gains tax has a ‘relatively weak effect on the cost of capital’ compared to other capital income taxes, he would increase the capital gains tax rate but offset it with a revenue-neutral tax reduction for new investment, perhaps by exempting a normal rate of return earned on new issues of corporate equity. Second, he would modify the method of realization-based taxation with a combination of accruals taxation of liquid assets and accrual-equivalent taxation for other assets, allowing a relaxation of capital loss limits. Auerbach (2012), supra note 8

141 For a proposal that New Zealand adopt an accrual method of taxing capital gains, drawing on the Haig-Simons definition of income ‘as the best operational index of equality’, see Rick Krever and Neil Brooks, A Capital Gains Tax for New Zealand (Victoria University Press for the Institute of Policy Studies 1990) 4, 43, 91, 106

142 Australia, Taxation Review Committee, Full Report (Chair: Ken Asprey, Asprey Review) (Australian Government Publishing Service 1975) paragraphs 7.4-7.6 and 23.82

143 For a prominent legal academic who has been thinking about this issue for some time, see Graeme S Cooper, ‘An Optimal or Comprehensive Income Tax?’ (1993-1994) 22 Federal Law Review 414; Graeme Cooper, ‘Theories of Modern Tax Reformers’ (2011) 15(1) Tax Specialist 2
even the comprehensive real income ideal, let alone comprehensive nominal income. ... Notwithstanding the declining theoretical support for comprehensive income taxation, many of the major reform exercises in Australia in the last three decades, inspired by the Asprey Taxation Review in the 1970s, have involved trying to move the legal tax base closer to comprehensive income. And I would argue that these reforms have, generally, been highly beneficial.\textsuperscript{144}

In the earlier section on economic theory and tax reform, we outlined the broader public policy context and the medium-term opportunities and challenges that provided the main focus and framework for the Henry Review’s analysis. From the Henry Review report, we now highlight three decisions in principle, then an outline of what was proposed and, finally, three issues of import for legal academics. First, the Review noted that

\textit{Recent theoretical and empirical research has brought a new perspective to the longstanding debate about the relative merits of comprehensive income taxation, under which savings income is taxed at a taxpayer’s marginal rate, and expenditure taxes, under which savings income is exempt. This work strengthens the argument that while there are potential benefits from taxing savings income, it should be taxed at a lower rate than labour income.}\textsuperscript{145}

Further, it observed that ‘\textit{c}omprehensive income taxation, under which all savings income is taxed in the same way as labour income, is not an appropriate policy goal or benchmark.’\textsuperscript{146} Second, the Review considered accruals taxation for easily valued capital assets but ruled it out because of practical problems, including concerns about the asymmetric tax treatment of assets taxed under the accruals regime and those taxed on realisation. Looking to the future, the Review suggested that ‘improvements in technology and changes in the operation of capital markets may mean that some of these practical impediments become less significant’.\textsuperscript{147}

So what were the final recommendations of the Henry Review? They chose the more cautious path of refining the hybrid personal income tax base employed in Australia. Consistent with an expenditure tax benchmark that exempts the returns to saving, superannuation and owner-occupied housing should continue to be taxed at a lower rate or exempt from income tax. Savings other than superannuation and owner-occupied housing should be taxed more consistently to improve the productivity and allocation of savings through the adoption of a broad discount mechanism.\textsuperscript{148} They recommended that the Australian government should phase in a 40% savings income discount for individuals for non-business related net interest income, net residential rental income (including related interest expenses), capital gains (and losses), and interest expense related to listed shares

\textsuperscript{145} Australia, \textit{supra} note 26, Pt 1, 19
\textsuperscript{146} Australia, \textit{supra} note 26, Pt 1, 32
\textsuperscript{147} Australia, \textit{supra} note 26, Pt 2, Vol 1, 64
\textsuperscript{148} Australia, \textit{supra} note 26, Pt 1, 32; Pt 2, Vol 1, 12-13
held by individuals as non-business investments. Auerbach has categorised this shift away from the capital income as being in accordance with what is now ‘close to a consensus among economists that high taxes on the normal returns to capital are counterproductive from an efficiency perspective and not needed to achieve distributional equity.’

And, the three issues of import for legal academics? Two relate to the boundaries that are inevitable when differential taxation occurs. First, the Review noted that work needed to be done on ‘how the boundaries between discounted and non-discounted amounts are best drawn to achieve certainty, reduce compliance costs, and prevent labour and other income being converted into discounted income.’ Second, the Review suggested work needed to be done on an existing tax law boundary: the boundary between individuals owning shares on capital account, which are subject to capital gains tax, and owning shares on revenue account, which are taxed as ordinary income. The Henry Review also proposed a number of simplifications of the capital gains tax regime and suggested that the law should be rewritten.

**United Kingdom 2006-2011**

Finally, we travel back to Europe, where the founder of modern optimal tax theory, Sir James Mirrlees chaired a review from 2006 to 2011, which brought together over 70 tax specialists from around the world with the general purpose of identifying ‘the characteristics of a good tax system for any open developed economy in the 21st century’, and two specific purposes of assessing how close the United Kingdom tax system conformed to those ideals and recommending realistic reforms for the United Kingdom. The Mirrlees Review was published in two volumes. The first volume, called *Dimensions of Tax Design*, is a series of commissioned chapters on 13 topics (including the base for direct taxation written by Peter Diamond and James Banks), with several commentaries on each chapter written by other experts (the commentators on the base for direct taxation chapter were Robert E Hall, John Kay, and Pierre Pestieau). The object was to draw out different views on each topic. The second volume, called *Tax by Design*, is the final report of the review. It is authored by a group consisting of Sir James Mirrlees, eight other economists and one lawyer. The final report employed optimal tax theory and three rules of thumb (neutrality, simplicity and stability) in identifying the characteristics of a good tax system in an open developed economy in the 21st century.

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149 Australia, *supra* note 26, Pt 1, 83, recommendation 14. The net residential rental income discount was contingent on reforms to the supply of affordable housing and housing assistance programs - recommendation 15, at 83. For preliminary evaluation of the 40% discount in relation to inflation, see Burman and White, *supra* note 17, 188-189

150 Alan J Auerbach, ‘The Taxation of Savings and Superannuation’ in Evans, *supra* note 17, 98

151 Australia, *supra* note 26, Pt 1, 83

152 Australia, *supra* note 26, Pt 1, 83

153 Australia, *supra* note 26, Pt 1, 84, recommendation 17. For a survey of over 300 Australian tax practitioners that identified significant compliance costs deriving mainly from the complexity of the legislative provisions, see Chris Evans, ‘Taxing Personal Capital Gains in Australia: Causes of Complexity and Proposals for Reform’ (2004) 19 *Australian Tax Forum* 371

Banks and Diamond in their chapter on the base for direct taxation in the first volume concluded that capital income or wealth should be part of the tax base but could find no support in optimal tax theory for the Haig–Simons idea of taxing annual capital and labour income in the same way. They added, ‘we suspect that positively relating marginal tax rates on labour and capital incomes is better than having separate taxation of the two sources of income.’\textsuperscript{155} In other words, they were not convinced about the merits of the dual income tax approach taken by an increasing number of countries in Europe.

One of the commentators on the Banks and Diamond chapter, Robert Hall, who is an advocate of progressive consumption tax, strongly argued for a zero rate of tax on personal capital income on the basis of the 1976 Atkinson-Stiglitz theorem and the Chamley (1986) and Judd (1985) theorem.\textsuperscript{156} Hall was critical of the ‘bias’ in Banks and Diamond chapter towards taxing capital income,\textsuperscript{157} adding ‘the chapter gives the impression that the authors lean in the direction of convincing the reader that taxation of capital income is a better idea than economists generally think.’\textsuperscript{158} Diamond has subsequently elaborated why the zero capital income taxation results from the theoretical literature, including the Atkinson-Stiglitz and Chamley and Judd theorems should not, in his view, be considered relevant for practical tax policy making.\textsuperscript{159} As noted in the section on optimal tax theory above, Diamond and Saez have suggested a path forward for economic analysis leading to policy recommendations, following the Meade Report approach.\textsuperscript{160}

Sir James Mirrlees and his fellow authors of the final report considered the Banks and Diamond chapter and the three commentaries but went their own way. They noted ‘the vast body of research’ but concluded that optimal tax theory did not provide an unequivocal recommendation on how to tax household savings.\textsuperscript{161} They did not consider they had sufficient detailed knowledge about the many ways individuals ‘differ with regard to savings behaviour based on underlying preference and opportunities.’\textsuperscript{162} They rejected the comprehensive income tax concept because its treatment of household savings did not achieve ‘neutrality over time or across assets’, it usually taxed the nominal rather than real return and it taxed on realisation.\textsuperscript{163} They characterised the United Kingdom realization-based capital gains tax as a ‘highly unsatisfactory tax’ reflecting ‘the fundamental tension

\textsuperscript{155} Banks and Diamond, supra note 29, 637
\textsuperscript{157} Hall, supra note 42, 651
\textsuperscript{158} Hall, supra note 42, 652
\textsuperscript{159} See the two articles discussed in the optimal tax theory section above. Diamond, supra note 78 and Diamond and Saez, supra note 77
\textsuperscript{160} Diamond and Saez, supra note 77, 184
\textsuperscript{161} Mirrlees (2011), supra note 18, 284
\textsuperscript{162} Mirrlees (2011), supra note 18, 285
\textsuperscript{163} Mirrlees (2011), supra note 18, 295-96
between the desire for a tax regime that does not penalise saving and one that treats similar levels of income similarly.'

So where did that leave the Mirrlees Review in relation to taxing household savings? Optimal tax theory did not provide an unequivocal recommendation and they rejected the comprehensive income tax concept. Instead, they employed the rule of thumb of ‘neutrality’, noting many practical reasons for using this assumption. They were prepared to depart from timing neutrality if research justified it. The Mirrlees Review also considered the dual income option but rejected it. Instead, they proposed to leave the normal risk-free return to personal capital income free of tax: no tax on interest earned on bank accounts, for example. They would, however, tax returns above the normal risk-free return (what they called ‘excess returns’). A key merit of their proposal, they argued, was that it would treat capital gains and cash income equally and not require inflation indexation. As they recognized, however, key questions remain. ‘Operationalizing it would create some complexities, including over the choice of the normal risk-free return, increased record-keeping requirements, and the treatment of ‘losses’ ... The record-keeping required ... would be somewhat more onerous than under some other systems, but no more than under a standard capital gains tax.’ For anyone who has worked with standard capital gains taxes, that assessment is no cause for cheering – whether by policy officials, lawyers and others seeking to implement it or by revenue officials, taxpayers and their advisors attempting to work with it.

Conclusion

This working paper by a former tax policy official and current tax law academic has been a reflection on the influence on proposals to reform personal capital gains taxation of two economic theories: the comprehensive income tax concept and optimal tax theory. After considering the role that economic theory can play in tax policy analysis in general and the evolution of the two theories, the working paper has examined the influence of these two theories in three tax policy reports prepared by the OECD and in selected public tax reviews and official reports on tax reform in six countries. Each of these reviews and reports decided what framework they would use to evaluate and reform this aspect of real world tax systems. Often, people from different disciplines participated in them. The question is whether there is a pattern of certain theoretical insights being discussed or accepted in these reviews and reports that indicates the possible direction of future tax reform design and possible legal design issues. And the answer from this selective survey is that there are

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165 Mirrlees (2011), supra note 18, 326, 40-41
166 Mirrlees (2011), supra note 18, 301-03
167 Mirrlees (2011), supra note 18, 302. The choice of the normal risk-free return to use and how often it is adjusted are real issues. Admittedly in the context of comparing income and consumption taxes, Shuldiner has suggested that in the US the risk-free rate of return should be significantly higher than the approach normally taken (US Treasury 30-day bill rate, adjusted for inflation over 50 odd years) and should be based on a different time period, benchmark and investment horizon, see Reed Shuldiner, ‘Comment’ in Aaron, supra note 23, 31, 35-37. The point for this working paper is that the choice of benchmark makes a real difference.
discernible patterns but the picture is even more polychromatic than that for policy and
practice because some of the theoretical differences are so fundamental: uniform or
differential taxation; taxation of part or all of the return to capital; and, the imposition of
low to high rates of taxation.

Economic theory does not focus on the capital revenue distinction or even the concept of
capital gains, as lawyers do. There is a conceptual gulf between tax law and practice and the
direction in which economic theory has developed. For tax professionals starting from the
income tax laws in their countries, ‘capital gains’ are often thought of as increases in the
value of assets, which are usually measured and taxed at the time of realization and
occasionally each year on accrual. By contrast, economic theory commonly distinguishes
between two to four slices of income from capital, none of which is called capital gains. In
the case of the four-fold distinction, the constituent parts of capital income are: the normal
or risk-free return; the risk premium; the supernormal return; and, the unexpected return.
Given this economic conceptualisation of capital income divides returns into categories
none of which is called ‘capital gains’, it has sometimes been necessary in this working
paper to consider ‘personal capital income’ more broadly rather than just ‘personal capital
gains’.

My understanding of the argument in Auerbach’s recent writing is that from the 1960s the
main theoretical debate about capital income taxation has moved from comprehensive
income to optimal tax theory in simple models suggesting no capital income taxation and
now to how some form of capital income taxation should occur, without returning to the
comprehensive income concept.168 In his 2009 survey of the evolution of tax and transfer
theory, evidence and adopted policy, Auerbach suggested that in relation to the taxation of
capital gains, we are now at a political impasse: ‘the realisation principle is no longer a
viable approach to taxation, but full accrual taxation is not yet feasible and alternatives to it
face political resistance.’169

This selective survey of the influence of economic theory on reform analysis and proposals
one step short of adopted policy has illustrated the continuing use of capital gains and the
initial development of returns to capital proposals. It has reviewed the evolution and
influence of the two economic theories on proposals to reform personal capital gains
taxation (and, where necessary, personal income taxation) in selected public tax reviews
and official tax reform reports in these six countries and tax policy analysis in three OECD
reports. This perspective has revealed a picture that is more motley than that arising from
focusing on theory, evidence and adopted policy:

- The legal concept of taxing ‘capital gains’ on realisation using Haig-Simons
  comprehensive income theory in South Africa and, at times, in OECD tax policy
  reports;

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168 Auerbach, supra note 8
169 Auerbach, supra note 1
• The economic concept of taxing ‘capital gains’ on accrual or accrual-equivalent using Haig-Simons comprehensive income theory in Italy for a short period and, at times, in OECD tax policy reports;

• The legal and economic concepts of taxing ‘capital gains’ using Haig-Simons comprehensive income theory and the ‘broad-base, low-rate’ and ‘neutrality’ rules of thumb in New Zealand;

• The economic concept of taxing ‘normal returns to capital’ using optimal tax theory considerations, either explicitly or implicitly, in the Netherlands and New Zealand;

• The economic concept of not taxing ‘normal returns to capital’ through providing a 40% savings income discount using optimal tax theory in Australia; and,

• The economic concept of taxing ‘above-normal returns to capital’ using the ‘neutrality’ rule of thumb in the United Kingdom Mirrlees Review.

Given the fact that public tax reviews and official tax reform reports are taking into account a wider range of views, including those of non-economists, and a wider range of factors, including broad national public policy matters, some differences from the Auerbach survey were to be expected. There are three features that stand out from the analysis in this working paper. The first is the important role often played by rules of thumb, such as ‘neutrality’ and ‘broad base-low rate’, sometimes forming initial tax policy frameworks or a starting point for policy analysis. The second is the continuing use of the Haig-Simons comprehensive income concept in many of these public tax reviews, official reform reports and OECD reports, long after most public finance scholars have ceased using this framework for their analysis. The third point concerns ‘return to capital’ proposals. There is disagreement about which return to capital should be taxed: the normal return or the above normal return.

And, the legal tasks and issues for the future? One important legal task is to help test and operationalize theoretical constructs such as the accrual-equivalent regimes or the rate-of-return-on-capital regimes, perhaps as part of a multi-disciplinary research effort to formulate a policy recommendation following the Meade report approach, as Diamond and Saez have proposed for economic research. In terms of the legal design issues resulting from proposals to tax some but not all of the returns to capital familiar issues such as the treatment of losses will arise: for the Mirrlees Review proposal to tax excess returns above the normal return, it is the treatment of ‘losses’ relative to the normal rate of return, for example. Another issue concerns the consequences of the normal rate of return varying as the benchmark interest rate fluctuates. Of course, there are always definitional and arbitrage issues with any form of differential taxation and the Australian Henry Review also called for more research and ideas on how existing capital boundaries might be more robustly defined. Then, there is the issue of how a new regime will be integrated into the

170 Diamond and Saez, supra notes 77 and 79
rest of the income tax, including the corporate tax. As always, there will be transitional and international aspects to consider.\textsuperscript{171}

\textsuperscript{171} See Julie A Roin, ‘Can Income from Capital be Taxed? An International Perspective’ in Aaron \textit{supra} note 23, 211
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