Capital gains taxation in Mexico and the integration of corporate and personal taxes

Francisco Gil-Díaz

Within the economics profession and in journalistic pieces, the taxation of capital gains has been the subject of continuous debate. On one extreme is the Henry-Simons[1] camp that insists on taxing income defined comprehensively, however impracticable, choice distorting, lifecycle inequitable and unrealistic it may be. On the other side is the consumption-based tax camp that includes most modern economists. In the middle is the camp that serves up all kinds of salads depending on the tastes of the proponents (or, to put it more elegantly, social engineers).

This paper will deal first with the tax-base issue to show how far removed from a practical reality is the ideal of so-called comprehensive income taxation. From this conclusion, the jump to consumption-based taxation is natural. But even then, because of the need to recognize the inevitability of the corporate income tax, there is a need to find a solution to the treatment of capital gains on corporate shares if individual consumption (or even income) taxation is to coexist with the corporate income tax. The conclusion is paradoxical and to some it may be somewhat surprising: the only

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way to avoid the double taxation of gains on corporate shares is to tax them, but to do so in a particular way. The method for treating the taxation of capital gains properly in this context is an old Canadian contribution. It is tax neutral and, therefore, avoids the type of tax arbitrage that concerned The Fraser Institute when it convened the 2000 Symposium on Capital Gains Taxation. But, before discussing this idea, it will be convenient to go into more detail concerning the real-life problems involved with the Simons definition.

Henry Simons´ global income approach

Echoing philosophers' equity ideals, economists have generally favoured progressive taxation as well as an income-tax base with a broad global definition. The required reference to a comprehensive tax base is Henry Simons' *Personal Income Taxation,* where he defines the ingredients required to measure the individual's increase in net worth. Such a concept includes wages, interest, rents, dividends, fringe benefits, subsidies, debt reductions, imputed rent to owner-occupied housing, inheritances, unrealized capital gains, scholarships, gifts, and perhaps even the imputed income of household work. Even while striving towards the attainment of this ideal, policy-makers who claim to have established a global-progressive system of taxation do not realize, or do not confess, how far they are from it, nor how inequitable and random the true incidence of actual income taxation really is.

Theoretical considerations are involved in optimal tax design but the most elaborate and dazzling theoretical construct has to recognize the reality upon which it will be applied. In an interconnected and global environment, policy-makers and politicians should become aware of nasty secrets widely known to taxpayers.

- A substantial portion of top salaries in high-tax countries is deposited in tax havens—just ask high salaried executives in European-based companies about compensation deposits in bank accounts abroad.
- Ingenious and forward-looking tax planning also avoids the fragmentation of large estates and all kinds of complicated ruses disguise substantial capital gains.

- Political lobbying converts income taxes into veritable gruyère cheeses through myriad deductions, concessions, and favourable treatments.
- Fringe benefits often cannot be individualized and taxed or are, because of political considerations, never fully included in the taxable income of individuals.
- In many countries, corporations and non-incorporated firms are taxed differently, with the income of the first frequently subject to double taxation.
- Dividend income is often double taxed or subject to diverse discriminations because of the "evils of distributed earnings."
- Across countries, the individual global income tax, the alleged great equalizer, often accounts for no more than 20% of total fiscal revenues.
- Global corporations readily relocate profits internationally according to tax minimizing strategies.
- A substantial portion of personal income, which stems from the implicit stream of services from owner-occupied housing, is usually not taxed.
- Because of the high mobility of financial capital, interest income is generally not taxed or, when taxed, its burden is shifted to the consumer.

Because of the practical and political reasons given above, the attainment of equity, based on the income tax, is a delusion, a Holy Grail that only serves to inspire the matins of the apostles of global income taxation. So much for the practicality of a comprehensive income tax and the attainability of horizontal and vertical equity.

But how about efficiency considerations? There is a broad consensus in the economics profession that taxes generally distort the choice between labour and leisure but that the income tax also distorts the choice between consumption and savings. A tax that generates equal revenue and comparable equity effects, based on consumption, would be preferable on this account.

The other attribute generally examined in taxes is their incidence and their effect on comparable net of tax incomes. From this perspective, another defect of the income-tax approach is that it views equity from a static point of view. It considers the ideal base for taxation to be all sources of income and the increase in the net wealth of the individual over a given period of time. It is fitting that this approach was perfected in the 1940s, together with the linear-static Keynesian consumption function, which considered current income as the explanatory variable of consumption and totally ignored life-cycle income. With some exceptions, economists tend to ignore the tax design and equity implications of a life-cycle or permanent-income approach to consumption behaviour.

If income is the vehicle towards achieving consumption and if consumption is the quintessential ingredient of a utility function, it is not clear from a theoretical standpoint why income should be the object of taxation instead of consumption. The indirect attainment of an objective, through the taxation of the means instead of the objective itself, might be justified when the objective is hard to define, to administer, or both. But in the case at hand it seems that the opposite is true. Consumption is much easier to tax, unless one wishes to tax consumption directly at the individual level. I return to this issue below.

Intertemporal or life-cycle considerations imply that if consumption is programmed throughout a lifetime in an effort to maximize an individual's utility, it makes sense to target it, instead of global income, as the object of taxation. Beyond practical considerations, income taxation will result in, at best, the equivalent to consumption taxation and, generally, in an inferior outcome. Savings and returns on savings are the tools used by individuals to average out consumption through time. Thus, the life-cycle approach suggests that, if the measure of an individual's utility wealth is consumption, it is the latter that ought to be taxed.

There are practical considerations as well. It is well known that consumption follows a more regular pattern through time than income. Individuals whose income is bunched up, frequently in the early stages of life, as is the case of entertainers, traders, athletes, and so on, face a more progressive income taxation and heavier average taxes than those whose income is more equally distributed through their life-times. The excess tax burden faced by such individuals cannot be eliminated except through extremely complicated lifetime-averaging techniques. The same will usually be true of highly variable incomes derived from such activities as farming, fishing, cattle raising and mining.

The inequities just discussed can be avoided in principle if the tax base and the tax rates are set up so that the present value of tax revenues is the same. Under these conditions, the lifetime incidence of both income and consumption base taxation will be the same and there is no a-priori reason to choose, on equity considerations alone, one tax over the other.

Collection costs are not the determinant of the appropriate choice between consumption and income tax bases. As Hall and Rabushka (1985) point out, consumption taxes can be designed to tax directly an individual or income-based taxes can be designed to be "indirect." On the other hand, collection costs should rather be a decisive factor in the choice between indirect and direct taxation since the collection and compliance costs associated with direct taxes can be considerable. Hall and Rabushka (1985) report a figure of 10% of revenue for the American income tax. However, a tax on wages is one simple direct tax that over the life-cycle is equivalent to taxing consumption.

Given the considerations above, an "income" tax that excludes imputed rents from owner-occupied housing, capital gains and interest income, does not appear to be inequitable but it will be unnecessarily distortive unless it also excludes rental income. Within such a framework, the next section will explore how not to tax capital gains when a corporate tax is in existence.

In summary, efficiency and equity considerations counsel consumption-based taxation because a consumption tax involves a lower number of distorted individual choices and because intertemporal equity is better served. If, on efficiency and intertemporal equity grounds, consumption is to be the preferred mode of taxation, it is evident that capital gains and other sources of capital income ought not to be taxed. One solution to the debate would then be to base taxes on consumption and be done with capital gains taxes.

But, despite all the ink spilt in discussing the theory and the persuasive arguments in favour of consumption taxation, it is a fact of life that a form of income taxation will prevail for a long time to come. Furthermore, and also on practical grounds, imperfect, inefficient, and inequitable taxation of personal income will also prevail to be an extended form of taxation. Under these rules of the game, an important issue to resolve before dealing with the appropriate way to tax corporate capital gains is: should corporate income be taxed twice by having both dividends and capital gains income subject to the income tax

If the answer is negative, the method of avoiding the double taxation of profits is to integrate individual income taxation with corporate income taxation. The exemption of capital gains from the income tax would not be sufficient to avoid double taxation because, under an integrated setup, individuals are entitled to a tax refund if their tax bracket is below that of the corporation. Integration encompasses more than the treatment of dividends. It requires a treatment of gains obtained through the realization of corporate shares symmetrical to the one given to dividends.

The interaction between dividend and capital gains income and its implication for the taxation of capital gains will be the subject of this paper. It will be seen that, to understand the treatment that ought to be given to capital gains income, the two income sources have to be considered jointly. The discussion will deal solely with equity shares and will not include other wealth accretions, such as real estate, art works, or in general the appreciation of any other asset. A succinct presentation of Mexico's perhaps singular experience in this regard will conclude the paper.

Integration of corporate and personal income taxation = disappearance of capital gains

It will be argued that, when dividends are taxed, it is inequitable and inefficient to exempt capital gains. However, it is well known that, if the personal and the corporate income tax are integrated, the tax on dividends will vanish. Under these circumstances, a symmetrical treatment of capital gains requires adjustments to provoke the virtual disappearance of capital gains taxation, as it should under an appropriately balanced non-distorting design. It will be shown that a simple exemption of capital gains will not do and that, paradoxically, a scheme to tax capital gains will, in fact, encourage people to avoid their taxation.

The concern about the taxation of capital gains has at least two origins: the technical, public-finance outlook from which many analysts point out that capital gains are generally overtaxed;[2] and the notion that capital gains are the ultimate manifestation of market, technological, or organizational efforts. As such, these rewards to entrepreneurship ought not even be taxed, lest the motor of economic growth is impaired and welfare reduced.

Digression on inflationary accounting

Before discussing the merits of the diverse modes that capital gains taxation can take, it will be convenient to deal with, and leave aside, the other significant source of double taxation and sometimes even confiscation of capital gains. Over taxation frequently occurs when the purchase price of an asset is not corrected for inflation to calculate its taxable gain. It may even turn into confiscation given a sufficiently high increase in the general price level. A creeping low inflation over a long period is all that is required for this effect to take place.

But, although the remedy for this misfortune seems obvious, beware of individual indexations to correct partial distortions. The reason for these distortions is that general price-level increases will tug at a corporation's balance sheet from different directions and the net result will differ from firm to firm, depending on the relative importance of monetary assets and liabilities. Depending on how several factors combine, corporate profits may be understated or overstated as the result of inflation. If a firm is a net debtor, it gains from inflation on this account, or loses from a net creditor position. The firm also loses from depreciation charges that, being based on the original (nominal) purchase price of capital assets, fall in real terms with inflation. Thus, profits and dividends are, because of inflation, distorted reflections of a firm's true results. This argument is also applicable to any accrued capital gain. While the latter may seem to have ended up being overtaxed in real terms, the gain may be due to inflation that lowered the corporate income tax and resulted in more untaxed reinvested profits. The converse argument also applies, of course: nominal taxation may account for the double taxation of losses!

Could it be that the general impression of over-taxation originates in the isolated perception of taxes? These taxes fall disproportionately on the sale of shares when it would be more appropriate to consider all the inflationary effects on the balance sheet of the firm whose shares were sold.

To conclude this section, it seems wiser to either not index at all or to index comprehensively, that is, to index the whole balance sheet and to carry its adjustments into the taxable profit and losses statement. Partial indexation will introduce an additional source of random variation in end results.

The dilemma—to tax or not to tax capital gains

Excessive capital gains taxation should not be viewed singling out capital gains as a special entity. This is the position of many proponents of capital gains tax reform, especially some vocal contemporary American advocates for the exemption of capital gains from the income tax. Abstracting from the unpredictable effects of inflation, over taxation of capital gains is a result of separate corporate and individual income taxes; it originates in the overall design of the income tax itself. Except for some European countries and Mexico,[3] among others, where the two taxes are integrated, corporate profits are taxed at the firm level and again when they are distributed. In this context, it must be understood that realized capital gains on shares are a form of profit distribution: if an investor decides to sell a corporate share, the proceeds of the sale are equivalent to a "home-made dividend" (Fama and Miller 1972). Therefore, if profits are taxed once at the firm level and again when distributed, symmetry requires that the same base and tax rate be applicable to capital gains.

If distributed profits and capital gains are taxed differently, people will tend to engage in tax arbitrage and to choose the lower taxed vehicle. Therefore, the correct, neutral and equitable goal is not a favoured treatment for capital gains but rather a symmetrical treatment of distributed profits and of capital gains. If the first are taxed twice, so should the other and, if the first are not adjusted for inflation, it is not clear why the other should.

On the other hand, there are no efficiency or equity grounds to double-tax corporate profits, if dividend and corporate profit taxation were integrated; that is, if only the individual shareholder were considered the unit of taxation, capital gains taxation would virtually disappear.

Under such a scheme, a corporate income tax is solely an individual income tax withheld at the source, just as is frequently done with wage or interest income. In this vein, individuals add up their various sources of income, including dividends, albeit grossed-up to determine the profit before corporate income tax, but then the corporate income tax would be creditable as a withheld tax in order to arrive at the individual income tax.

The end result of this procedure is that corporate profits would be taxed only once at the individual's level. Such a design requires parallel corrections in the way capital gains are taxed. The seller of a share would be allowed to modify its purchase price when calculating the difference between the sale and purchase prices to arrive at the taxable capital gain. The required adjustment would be to allow for taxed reinvested profits to be added to the purchase price of the share and to deduct corporate losses. When the individual and the corporation's marginal tax rates differ, a grossing-up and tax-credit procedure similar to the dividend method is required. This method is discussed below.

To simplify the first example, the two rates will be assumed to be equal. In this case, since most capital gains originate in the appreciation of share values derived from the reinvestment of profits, the deduction of these investments from the capital gain should cancel out the capital gains' tax base.

There is a caveat to the last assertion because, beyond the mere reinvestment of profits, a share's value may appreciate because of the market's appraisal of the growth potential of a particular firm, an appreciation beyond the average expected marginal return on other investments. Examples abound, such as Wal-Mart, Microsoft and, until recently, the "dotcoms."

Even in this case, the adjusted purchase-cost procedure outlined above should generate neutrality; that is, no taxation of capital gains or, equivalently, no double taxation of profits. Consider for simplicity (a) no corporate income tax; (b) a firm whose profits are reinvested; (c) a 10% annual discount factor; (c) a riskless environment; and (d) a change of market sentiment so that a share that had been expected to yield the same 10% as the rest of the market is suddenly expected to appreciate 20% the following year. Assume also a \$100 purchase price for the share and that, after the 20% appreciation, the share is expected to continue yielding 10% per year. The original purchaser of that share, who paid \$100 for it, can now sell it for \$109.1 and pay a tax of 91 cents, if we assume a proportional income tax of 10%. If the original holder sells the share immediately after its higher expected return is known to the market and if the new owner sells it at the end of a year for \$120, the tax adjusted cost of the share for the latter will be \$129.1, since the firm generated and reinvested \$20 in profits. The second seller of the share will be able to deduct from his global tax bill losses equal to \$9.1, for a tax saving of 91 cents. The capital gains tax paid by the first individual is thus offset, except for the difference in present value, by the tax saving of the second individual, who obtained a 10% return on the purchase plus the tax-saving on a capital-gains deduction.

However, the numbers above cannot be the outcome under a perfect capital market, while the original asset holder obtained an extraordinary return. The unexpected and sudden appreciation of the share also brings the buyer a return higher than 10% if this tax savings is added to the return on the asset. In a competitive capital market, the original holder will ask somewhat more than \$109.1 for the shares in order to let the second holder earn a return just equal to 10%. The sale price in this case will be \$110. At this price, the second holder will get a \$10 return when selling the share after one year, plus a tax saving equal to a 10% tax rate on the difference between the fiscal cost \$110 + \$20 = \$130 and the \$120 sale price, or a savings of \$1. A return of \$11 on a \$110 investment is just equal to the market discount rate of 10%. (The method for arriving at this number with this simple set of assumptions is presented in the Appendix.)

What is of interest here is that, even though the original shareholder pays a tax on the capital gain, the net after-tax income will be the same as if there had been no tax. Since the discount rate is 10% and the net increase in the wealth of this individual is \$9.1, the return is the same that would obtain if a capital gains tax did not exist. The original shareholder recovers the tax saving of the second asset holder because the sale price of the share is bid up exactly in the amount necessary to recover the tax. In a competitive market, the original shareholder will be able to capture the tax saving that will eventually be realized by the second holder.

Since for simplicity the numerical example assumed away the corporate income tax, it did not illustrate the important point of how to adjust at the individual level for the tax paid by the firm. Another numerical example will take care of this omission. Assume a share valued at $100, a profit of $10, a corporate income tax of $5, and a dividend of $5 to an individual in a 30% tax bracket. The individual will add to other income the grossed-up dividend ($10), calculate the tax ($3), and credit the corporate income tax formerly paid on that dividend ($5) to arrive to a claim of $2 on the Treasury for a total net income from the dividend of $5 + $2 = $7, that amounts to the disappearance of the corporate income tax.

If the corporation does not pay out a dividend and the individual wishes to obtain the same cash income, the procedure is analogous to the mechanism described above. The share will be sold for $105 and its adjusted cost will also be $105. But, this would be the end of the story only if the shareholder pays a marginal tax rate equal to that paid by the corporation. If the rates are different, the individual will be allowed to credit the $5 tax paid by the corporation to a total taxable income augmented by the grossed-up, unadjusted capital gain ($10), in order to generate the same $2 tax refund.

Therefore, even in a case of extraordinary gains, the taxation method proposed ensures that there is no capital-gains tax. This argument is not new: it has simply been forgotten, since it was presented, in a different fashion, in the report by the Royal Canadian Commission on Taxation (known also as the Carter Commission) in the 1950s.

I hope the discussion above helps to clarify some issues on the important and delicate matter of capital gains taxation reform. A change that simply eliminates the taxation of capital gains will contribute to the disappearance of the tax on dividends and of double taxation as well, at least on the shares of those firms with stock-listed shares. But if this is the desired output, why do it through the back door? And, why not adjust the burden of the tax to the lower rate that should be borne by individuals in the lower brackets?

The arguments presented here suggest that the proper solution is to eliminate both income-tax sources simultaneously. Alternatively, if one wishes to benefit lower-income tax payers, one should apply the integration recipe outlined above regarding capital gains and dividend taxation to transform the corporate income tax into a tax on the individual's income. This solution is much preferable to simply abolishing the capital gains tax because its elimination would turn individuals into tax planners engaged in the elimination of the tax on dividends through tax arbitrage. However, the owners of medium-sized and small-sized firms, for which there is not a ready and liquid stock market, would have trouble selling their shares and would, thereby, be stuck with the tax on dividends. Therefore, whoever claims that reduced or zero capital gains taxation is a benefit for the small entrepreneur should concentrate such intellectual efforts elsewhere.

Zero capital gains taxation would also allow the total avoidance of taxation on those firms where, because of differences between their accounting and fiscal accounting rules, capital gains are realized despite no apparent gain. To close this loophole completely it also has to be established, as was done in Mexico, that realized profits, through dividends or capital gains, will be taxed even if they are generally exempt, when they are derived from profits that did not previously pay the corporate profits tax.

However transparent and non-distorting, the integration solution has serious drawbacks. The accounting requirements are complex and many years of information and documentation are needed. Besides, in countries where the estate tax has contributed to place large amounts of corporate shares in the hands of non-profit institutions, the revenue loss from an integration scheme could be large. This latter problem might be dealt with by not having the corporate tax be definitive in the case of shares held by non-profits, and a partial solution to the accounting and computing complexities might be sought in a rate structure low enough for both taxes with equal proportional rates.

The evolution of the capital gains tax in Mexico

The treatment above was not incorporated into Mexican tax legislation in one fell swoop nor were all its ingredients fully implemented. Given the sharp general price increases of the 1970s and an expectation that inflation would continue, it was deemed convenient at the time to correct in real terms the purchase cost of assets. The solution was to include in the legislation a table constructed with the price levels of the former 50 years.

Another reform had to do with the need to correct for the bunching in time of capital gains, since they are not recurrent for most individuals and may, therefore, be taxed at an extremely high marginal rate simply by adding overall gains to the rest of taxable income. Therefore, a simple averaging procedure was introduced to ease the impact of accumulation.

The other important reform was to add reinvested profits—corrected for inflation—to the adjusted purchase cost of a share, after having deducted any losses and distributed profits. The adjustment does not include the credit for taxes paid in excess by the corporation but, as long as the personal and corporate maximum tax rates coincided, the effect of this omission was probably negligible. The top individual rate is reached at relatively low income thresholds so that most shareholders' marginal tax rate was the same as that of the issuing corporations. This is no longer true since 1994, when the corporate rate was brought below the top personal tax rate. Since then, the corporate rate has slid to 30% and the personal rate rose to 40% in January 1999.

The procedures described above apply to assets held by both individuals and firms, except that capital gains in stock-listed shares owned by individuals continue to be exempt in order to avoid administrative complications. The exemption of individually held stock-listed shares from the capital gains tax has been in force for several years with probably no major fiscal consequences, specially given that, up to 1999, the personal dividend tax was fully integrated into the corporate income tax. This is because, if corrections are made for inflation and reinvested profits, the resulting consolidated tax base for the shares of listed corporations turns out to be either minimum or negative, although there are times when sharp increases in the stock-market index suggest otherwise.

When corporate tax rates are below the top individual marginal income tax rates, this exemption allows the tax consequences of the spread between the personal income tax rate and the corporate tax to be either avoided or deferred. This is done through limiting dividend distribution and letting shareholders obtain their income through exempt capital gains. However, as the top personal marginal income tax rate came to equal the corporate income rate, the incentive to switch the gain into the shares of unlisted companies disappeared. But, the distortion has reappeared under the recent Zedillo reforms that lowered the corporate tax to 34%, reintroduced double taxation through a dividend tax, and raised the top individual marginal tax to 40%.

Before the recent Zedillo reforms, the changes performed on the capital gains tax were intended to improve fairness and to "lubricate" the capital market. An efficient capital market is of utmost importance for sound resource allocation. The former tax on nominal gains led to the strangling of asset transactions because individuals and firms preferred to hold on to their assets rather than incur a tax on gains that were merely nominal. By showing their portfolio valuations at current market prices and excluding potential liabilities stemming from the tax due on the sale of the assets, firms could also better leverage their balance sheets.

As explained above, the capital gains mode of taxation is simply a reflection of an integration procedure adopted between the individual and corporate income taxes, a reform that was aimed at improving both fairness and efficiency.

Initially, the procedure allowed firms to deduct paid dividends just like any other deductible item or cost. It also required a withholding tax at the maximum marginal rates on individual income, creditable by the recipients. The same procedure was applied to interest paid to individuals.

Transfers of dividends among firms were also deductible and cumulative, which allowed interrelated firms to offset losses instantaneously from one side of their operation against gains on the other. This possibility was deemed particularly important within an inflationary environment.

Another reason to adopt an integration formula using a dividend deduction is that, in the first stage of the reform effort, an integration scheme based on an imputation method was introduced. This proved complicated for taxpayers and was later abandoned. Subsequently, when corporate and top personal income tax rates were aligned, the dividend deduction was replaced by a dividend exemption.

With the enactment of these reforms and price stability, the distortion that encouraged debt financing over equity financing was virtually corrected. With inflation, however, the deductibility of real-debt amortization through interest payments created an enormous attraction to issue corporate debt until the tax treatment of both interest income and expense was corrected for inflation.

Appendix

Assumptions and Definitions

- Let V_0 be the purchase price paid by the original owner of the share.
- Let V_0^1 be the sale price after a new higher return is announced. The new return higher (g per year) than previously expected is known by the market seconds after V_0 was paid for the share.
- Let r be the discount rate and "normal" rate of return in the market.
- t is the average and marginal tax rate equal for everybody.
- The sale price V_1 of the share after one year will be

$$V_1 = V_0\,(1 + g)$$

$$\frac{V_1 - t[V_1 - (V_0^1 + gV_0)]}{V_0^1} = 1 + r$$

$$\frac{V_1 - tV_1 + tV_0^1 + tgV_0}{V_0^1} = 1 + r$$

$$V_1 - tV_1 + tV_0^1 + tgV_0 = (1 + r)V_0^1$$

$$V_1(1 - t) + tgV_0 = (1 + r)V_0 - tV_0^1$$

$$V_1(1 - t) + tgV_0 = (1 + r - t)V_0^1$$

$$V_0^1 = \frac{V_1(1 - t) + tgV_0}{1 + r - t} = \frac{V_0(1 + g)(1 - t) + tgV_0}{1 + r - t}$$

$$V_0^1 = \frac{V_0(1 + g)(1 - t) + tg}{1 + r - t}$$

Notes

1 The classic reference for a comprehensive income taxation definition is Simons 1938.
2 The postponement of the gain does not lower the present value of the tax. See Gil Díaz 1982.
3 This comment is no longer fully applicable to Mexico where recent reforms have destroyed the former symmetry and neutrality of its combined personal and corporate income-tax structure.

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