

Funding the Future

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There has been some discussion on Twitter and some mention in comments on this blog on the subject of indexation relief for capital gains tax purposes. The suggestion has been made that I should include the reintroduction of this relief in my proposed reforms.

I completely disagree. Let me explain the practicalities first and then offer some theory.

Indexation relief supposedly allows for the impact of inflation on capital gains. So, instead of a capital gain being computed by deducting the cost of the asset sold from the proceeds of sale, it is computed by deducting that cost as inflated by an index such as the consumer prices index for the period during which it was owned, with this inflated sum then being deducted from sales proceeds.

For example, if an asset was acquired for £1 million and sold for £1.5 million with the relevant price index increasing by 20 per cent during the period of ownership, the unadjusted gain would be £500,000 (£1.5 million, less £1 million) but the inflation-adjusted, or indexed, gain would be £300,000 (££1.5 million less £1 million and less £1 million multiplied by 20% indexation relief, or £200,000).

I suggest that there is no logic to this in a tax system where horizontal tax equity is sought and the only relevant capital maintenance concept is financial. Indexation was simply a ruse to maintain capital and the advantages of wealth by way of undertaxing it, in my opinion.

The theory of this is explained in the following note that was [included in the note already published on the methodology of The Taxing Wealth Report 2024](#).

The principle of horizontal tax equity requires that all increases in the financial well-being accruing to people in equivalent circumstances within a population be taxed in equal amount whatever the origin of that increase in financial well-being might be.

To put this in context, it should not matter whether this increase in financial well-being

arises from employment, self-employment, a rent, a return on savings in whatever form paid, a capital gain or, maybe, a gift. Each of these activities increases the financial well-being of the recipient and in that case if a tax system is to be equitable there should be no discrimination in the amount of tax paid by persons in equivalent circumstances if they are to enjoy an increase in their financial well-being for any of these reasons.

Importantly, horizontal tax equity applies to all sources of increase in a person's financial well-being, and not just to their income. In other words, it is indifferent to whether that increase in financial well-being arises as a consequence of income earned (whatever its source) or increases in wealth (again, irrespective of the origin of that increase) or gifts.

This logic is based upon standard microeconomic theory. Based upon that theory, which in this case appears to accord closely to observed reality, there is no reason to think that a person should, or does, value their increase in financial well-being differently as a consequence of its source. What matters to them is the fact that their well-being has been enhanced. As a consequence, tax differentials that discriminate between the origins of increase in financial well-being are contrary to the principles of horizontal tax equity.

This concept of indifference as to source is also implicit in modern accounting theory and in the accounting standards used to record the income of companies both in the UK and internationally. The primary method of computing the income of any entity using these standards is to compare the net worth of a company at the end of a period (£A) with the net worth of that same company at the beginning of the period (£B) having allowed for sums withdrawn from the entity during the period by its owners, whether by way of dividend, share buyback or other means (£C), and the issue of new shares or other equity (£D).

In other words, profit or income (£Y) is calculated as:

$$\text{£Y} = \text{£A} - \text{£B} + \text{£C} - \text{£D}$$

This may come as a surprise to those who presume that the income of an entity during a period is the figure included as net profit after tax in the profit and loss account or income statement of the entity in question (£E). This is not the case. The movement in the value of the balance sheet at the end of a period (£A) is, instead, reconciled with the value at the beginning of the period (£B) by publication of three separate statements:

- * The income statement (or profit and loss account, as some might know it), which estimates the net sum earned from trading, having allowed for tax during the course of the period (£E).
- * The statement of comprehensive income for the period, which recognises the change

in the market value of the assets and liabilities of the enterprise during the course of the period when stated at fair market value at both the opening and closing dates, some of which movements may be taxable. (FF)

* A statement of the change in equity arising during the course of the year, which explains the sums withdrawn from the entity during the period by its owners, whether by way of dividend, share buyback or other means (FC), and the issue of new shares or other equity (FD).

As a result, and given that the changes in equity have already been included in the calculation noted above, earnings (FY) can also be stated as:

$$FY = FE + FF$$

To translate this to the context of this note, the earnings a person has during a period broadly equate to the earnings a trading entity records in its income statement (FE). It is this figure that most think represents their total income in the year. This idea is also implicit in most tax systems, largely because almost all of our taxes were created before modern theories of income and accounting were created.

This idea of income is, however, wrong. Within the context of taxation, the only relevant criteria of capital that can be used for measurement purposes is a financial one since tax can only be paid using money and can only be charged on tax bases that can be measured in monetary terms. In that case, a person's total income in a period must be their increase in net worth having allowed for what they have consumed and should therefore also include the change in the fair value of the assets that they own and sums that they owe during the course of period, as is reflected in modern accounting (FF). In that case, horizontal tax equity needs to be based upon this concept.