

Adam Smith's Philosophy on Taxation

By J.G.M. Jacques CA (SA)

INTRODUCTION

Adam Smith is most famous for his book, "The Wealth of Nations", and of this momentous work two aspects spring readily to mind: his description of the "Invisible hand" of the market and his four canons of taxation. These four canons (Smith actually called them "maxims") have been summarised in four words: equity, certainty, convenience and simplicity, and tax legislators ever since have tried, with varying degrees of success, to make their taxes meet these criteria.

Smith's chapter on taxation, "Of taxes", starts: "The private revenue of individuals arises ultimately from three different sources: Rent, Profit, and Wages. Every tax must finally be paid from some one or other of these three different sorts of revenue, or from all of them indifferently." He then sets out his four maxims and in the following eighty-two pages describes the various taxes imposed on rent, profit and wages, measuring them against his four maxims. This is a most interesting part of The Wealth of Nations because we find that even in 1776 there were few taxes that are unknown today; and there are few taxes today that were unknown to Adam Smith.

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In spite of this, few modern tax legislators seem to have bothered to have read Smith's chapters on taxation. Had they done so, it is unlikely that we would be encumbered with the type of taxes that we have today. Smith is scathing about our three main sources of revenue: company tax (taxes upon profit), income tax (tax upon the wages of labour), and G.S.T. (taxes upon consumable commodities) so let us examine in detail what he has to say about these taxes.

TAXES ON PROFIT

Smith divides taxes upon profit into two: taxes on interest, and taxes on profit after interest. Of the latter he says that this "is evidently a subject not taxable directly". Profit "is the compensation for the risk and trouble of employing stock". If the owner of the stock does not receive compensation, he will either not continue his business or he will pass on the tax, "in which case the final payment of the tax would fall altogether upon the consumers of those goods."

The taxation of interest appears to be capable of being taxed directly, but Smith puts forward an argument against this, and he could well have been writing in South Africa in 1987.

"The proprietor of stock (capital) is properly a citizen of the world and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to vexatious inquisition, in order to be assessed to a burdensome tax and would remove his stock to some other country where he could either carry on his business or enjoy his fortune at his ease. By removing his stock he would put an end to all the industry in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock but the rent of land and the wages of labour would necessarily be more or less diminished by its removal."

We are told often enough that disinvestment has more to do with economics than politics; Adam Smith it seems, would agree.

An off-shoot of "Taxes upon profit", is "Taxes upon the profit of particular employments." Here Smith is considering taxes such as liquor licences, trading licences, the special excise duty on brewers and so on. Again Smith tells us: "a tax upon the profits of stock can never fall finally upon the dealers but always upon the consumer and generally with some overcharge." Here we have a theme which Smith repeats a number of times, that many forms of taxation are a direct cause of price increases.

TAXES ON LABOUR

The next major topic that Smith deals with is: "Taxes upon the wages of Labour". These taxes are said today to constitute a major source of state revenue, so it is instructive to see what he said about them. He deals with this subject in just over three pages, which perhaps exemplifies the contempt with which he treats it.

"Absurd and destructive as such taxes are, however, they take place in many countries."

"A direct tax upon the wages of labour, could not properly be said to be even advanced by him In all such cases, not only the tax but something more than the tax would in reality be advanced by the person who immediately employed him."

"In all cases a direct tax upon the wages of labour must, in the long run, occasion both a reduction in the rent of land and a greater rise in the price of manufactured goods, than would have followed from the proper assessment of a sum equal to the produce of the tax partly

upon the rent of land and partly upon consumable commodities."

If these taxes do not cause an increase in the price of labour, then says Smith, they will cause a fall in the demand for labour. The decline of industry, unemployment and a reduction in the gross domestic product are the effects of such taxes. "Absurd and destructive as such taxes are, however, they take place in many countries." Need one say more?

There is, however, one more thing to say about the subject. The salaries and perks of civil servants are not the same as those of traders and professions which are "regulated by the free competition of the market." In Adam Smith's opinion the salaries of civil servants are perhaps higher than required: "the persons who have the administration of government being generally disposed to reward themselves rather more than enough. The emoluments of offices, therefore, can in most cases very well bear to be taxed and is always a very popular tax."

We have now dealt with taxes on Profit and Wages; the taxes on rent we shall leave to last. The remaining topic is therefore - "Taxes which fall indifferently upon every different species of revenue." In Smith's view there are only three "species of revenue" - rent, profit and wages; taxes which fall on all three without falling specifically on any one source are dealt with under this heading. Smith classified them into two; capitation taxes and taxes upon consumable commodities.

Smith dismisses taxes on consumables in the same way that he dismisses taxes on profits and on wages.

INFLATIONARY TAXES

Capitation taxes, of which the poll tax and the wealth tax would be examples, are probably the worst in Smith's book. They are unequal, arbitrary and uncertain and their only advantage from the tax gatherer's point of view is that they are inexpensive to levy. In Adam Smith's day these appear to have been fairly common taxes.

Smith takes 38 pages to discuss taxes on consumable commodities. This was more in view of the importance of such taxes in the eighteenth century, rather than Smith's regard for the principle of the tax. In fact, Smith dismisses taxes on consumables in the same way that he dismisses taxes on profits and on wages. He does, however, distinguish between necessities and luxuries and reserves his attack on this tax for that on necessities. A tax on luxuries he believes to be in the interests of the poor, preventing them from squandering their hard-earned money on such items. But a tax on "the necessities of life operates exactly in the same manner as a direct tax upon the wages of labour. The labourer though he may pay it out of his hand, cannot, for any considerable time at least, be properly said even to advance it. It must always in the long-run be advanced to him by his immediate employer in the advanced rate of his wages.

His employer, if he is a manufacturer, will charge upon the price of his goods this rise of wages, together with a profit, so that the final payment of the tax, together with this overcharge, will fall upon the consumer." Smith knew only too well what an inflationary spiral was all about! Continuing in this vein, he says: "The middling and superior ranks of people, if they understood their own interest, ought always to oppose all taxes upon the necessities of life, as well as all direct taxes upon the wages of labour. The final payment of both the one and the other falls altogether upon themselves and always with a considerable overcharge."

ALTERNATIVE REVENUE

If Adam Smith is not particularly in favour of any of the taxes discussed so far, which type of tax is he in favour of? It would be simple to say the tax on rent, that being the only tax not yet discussed, but it is not quite that easy. Certainly the tax on rent is the short answer but how do we know that? Smith deals with this topic at some length, but it is mainly in other sections in his chapter on taxes that we find his endorsement of this form of taxation.

In the section on Taxes on Profit and specifically dealing with the taxation of interest, Smith mentions that there are "two different circumstances which render the interest of money a much less proper subject of direct taxation than the rent of land." Firstly the quantity and value of land can never be a secret and secondly, land is a subject which cannot be removed.

The fundamental difference between the owner of land and the owner of capital, is that the owner of land is a citizen of the country, whereas the owner of capital is a citizen of the world.

In the section on the taxation of wages, Smith discusses how in the long run such a tax will result in a greater reduction in the rent of land and a greater increase in the price of manufactured goods, "than would have followed from the proper assessment of a sum equal to the produce of the tax partly upon the rent of land and partly upon consumable commodities." (It must be assumed here that he is talking about luxuries, given his attack in a later section on the tax on "necessaries".)

"The middling and superior ranks of people, if they understood their own interest, ought always to oppose all taxes upon the necessities of life."

The taxation of rent is a subject with deep philosophical and political differences of opinion; Adam Smith recognises the problem and his intellectual genius steers a path of reason through this minefield. As a true academic he holds himself aloof from enthusiastic endorsement of any cause. In fact he gives his French acquaintances, the Physiocrats, a rap on the knuckles for their enthusiasm for the taxation of land, "as the most equitable of all taxes". Nevertheless it is known that Smith had a high regard for the leader of this group, Francois Quesnay and The Wealth of Nations would have been dedicated to Quesnay had he not died before

publication. This is significant because close reading of the sections on the rent of land reveal Smith's belief that this form of taxation, if properly administered, is the only tax which meets all the conditions of his four maxims.

Smith divides his discussion on "Taxes upon Rent" into three sections: "Taxes upon the Rent of Land", "Taxes which are proportioned, not to the Rent but to the Produce of Land" and "Taxes upon the Rent of Houses". "Land" in Smith's terminology generally meant agricultural land and "Houses" meant residential, business and industrial property including both land and the improvements. It is in this latter section on the tax upon houses that we find Smith's philosophy of taxation coming together. Here he specifically distinguishes between the "ground rent" and the "building rent"; with agricultural land the distinction between raw land and improvements is not as important.

VALUE FOR VALUE

"Ground rents are altogether owing to the good government of the sovereign, which by protecting the industry ... of the people enables them to pay so much more than its real value for the ground which they build their houses upon." It is this good government which creates the fund out of which the tax is paid. "All taxes", said Smith, "ought to fall as equally as possible upon the fund which must finally pay them." If this fund is created in the first place by the "sovereign" then no possible hardship can be placed on those who apparently pay the tax. Why? Because "both ground-rents and the ordinary rent of land are a species of revenue which the owner enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the state, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth and revenue of the great body of people, might be the same after such a tax as before."

Adam Smith is indicating here that there is a natural fund from which taxation can be taken without harming the economy in any way. This fund is created by the "good

government of the sovereign" and so, in a way belongs to the sovereign. This is a concept which is almost unheard of today. It was dismissed a long time ago, mainly by vested interests, who maintained that Smith knew nothing of the modern industrial world. Taxation of land rents may be suitable for an agricultural society, but would not raise sufficient revenue for the government of an industrial country.

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The theory has never been tested but it seems inconceivable that the huge increases in rental value of land would not have been sufficient to support Smith's concept of a tax that would meet perfectly his four maxims of equity, certainty, convenience and simplicity and meet the revenue requirements of modern government. Politicians and economists have read Adam Smith; it is just that they have chosen to ignore him. Almost certainly we are poorer for such ignorance.

CONCLUSION

The chief aspect of Smith's philosophy which is overlooked today is his concept of the three sources of revenue, viz. rent, profit and wages and his analysis of the effect of taxation on each. Today it seems that such a concept is of no consequence and the effect of taxation on the various sources of revenue is not a subject for debate. Certainly there is vast debate on subjects such as direct versus indirect taxation or the methods of arriving at the quantum of taxable income, but seldom if ever does one hear a philosophical debate of the simplicity or incisiveness of Adam Smith's. The horrendous inflationary effect of taxation on some sources of revenue, a subject Smith deals with over and over, is not debated today. Perhaps there is a fear that we shall come to the same conclusion as Adam Smith; that in the final analysis there is only one true source of taxation, the rental value of the land.

Adam Smith & Henry George

By J.G.M. Jacques

In my analysis of Adam Smith's chapter on taxation, I have come to the conclusion that Adam Smith believed that the taxation of the rental value of land was the best and fairest method of taxation. It may not be easy to deduce such a conclusion, but the facts are there, and the more one reads the chapter on taxation the more obvious it is. Even his maxims of taxation point to this: in the first maxim Smith says taxation should be "in proportion to the revenue which they respectively enjoy under the protection of the State."

Now in Smith's day, "rent" and "revenue" were synonymous. Certainly revenue only meant income from

an investment and did not include wages and salaries, and in the 18th century most investments were in landed property. Also his phrase "under the protection of the State" is amplified later in the chapter when, dealing with the subject of tax on ground-rents (ie. site value tax), he says, "Nothing can be more reasonable than that a fund which owes its existence to the good government of the State should be taxed peculiarly."

I am emphasizing this point because there appears to be a perception amongst Georgists, from Henry George onwards, that Adam Smith did not really understand the significance of a tax on the rent of land, or if he did, he did

not stress its importance because he was in the pockets of the landowners. It is true that Smith received a living from the Duke of Buccleugh mainly for services rendered as the tutor to the Duke's son, and this living continued for the rest of Smith's life. Nevertheless an important distinction must be drawn between Adam Smith and Henry George: Smith was an academic and George was a sailor/printer turned economic visionary. The Wealth of Nations is, to give its correct title, "An inquiry into the Nature and Causes of the Wealth of Nations"; "Progress and Poverty", on the other hand, is "An inquiry into the cause of industrial depressions of increase of want with increase in wealth ... The Remedy." It proclaims a great truth and is written with missionary fervour. Henry George was not and did not pretend to be an academic. He was a simple man troubled by the injustice he saw around him, especially in the great centres of economic wealth; and to whom the truth suddenly dawned as he stood on a hill overlooking San Francisco Bay. From that moment, Henry George embarked on his mission to address economic injustice by the simple expedient of the "single tax" and that mission is continued by his followers world-wide.

The question that needs to be asked, however, is this: did Henry George really read The Wealth of Nations, especially the chapter on taxation? In his book "The Science of Political Economy", he deals at fair length with Adam Smith, but rather than give an analysis of Smith's philosophy vis-a-vis his own, he tries to explain why The Wealth of Nations did not have the impact on economic thinking it should have, given Smith's own influence and his association with the Physiocrats. Nowhere does he quote Smith's chapter on taxation; in fact "The Science of Political Economy" hardly deals with taxation at all. It is, in fact, largely a complaint that so few others have seen the truth as George saw it. Henry George should have kept his eye on the ball; so should many of his followers today. It is not relevant that others do not see or do not wish to see what you have seen and know. That is their problem, not yours. Knowledge is one and is indivisible - you cannot transfer universal knowledge from one person to another. The knowledge comes in a moment when the obstacles preventing its realisation are removed - in George's case, on a hill overlooking San Francisco Bay after pondering the problem for many years before. He then set out this knowledge in his brilliant book "Progress & Poverty" and it has retained its freshness because it reveals a universal truth. But Henry George took his eye off the ball and tried to convert the whole world. That is why "The Science of Political Economy" has nowhere near the impact of Progress & Poverty.

Adam Smith also set out universal truths and that is why his book retains its appeal. Adam Smith said clearly what every Georgist wants to hear, that "ground rents are a still more proper subject of taxation than the rent of houses". "Both ground rents and the ordinary rent of land are a species of revenue which the owner enjoys without any care or attention of his own. Though a part of this revenue be taken from him ... no discouragement will thereby be given to any sort of industry"; and so on throughout the chapter on taxation. If politicians and

economists choose to ignore this aspect of Adam Smith's teaching, that is their problem. Nevertheless, Adam Smith remains today in the forefront of liberal economic thinking; if Georgists want this thinking spread abroad they must study him properly. Perhaps then Adam Smith's genius will truly come into its own.

Association for Incentive Revenue Research

STATEMENT OF OBJECTIVES

1. To study and research the incentive and disincentive effects of modern taxation on production and employment and on the relations of men in society.
2. To study the natural laws governing the relations between men in society, the understanding of which is essential to establish economic justice and social stability.
3. To teach these basic principles at all levels of society.
4. To disseminate information relating to the above.

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- No. 7 Site value rating encourages growth: Statistics prove theory.

EDITOR'S COMMENT

The editor fully endorses Michael Jacques' views on Adam Smith's philosophy of taxation and strongly commends it to the reader's serious study. Kindly send as many copies as possible to friends and politicians. An understanding of the significance of this interpretation is essential to the future economic and social stability of every nation, both capitalistic and socialistic states.

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