The Political Economy of Public Finance in Britain 1767–1873

Takuo Dome

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The Political Economy of Public Finance in Britain 1767–1873

Until now, no book has examined and compared the thought of the 'classical economists' from the perspective of public finance rather than that of pure theory.

This volume critically analyses and compares the writings on government expenditure, taxation, and public debt of thinkers such as James Steuart, Adam Smith, Jeremy Bentham, Thomas Malthus, David Ricardo, John McCulloch, and John Stuart Mill. These key figures are united by their struggles with fiscal theory – an important feature in the formation and development of political economy.

An original and intriguing read, this book breathes fresh life into the history of economic thought. Dome's clear and exciting arguments will make for essential reading for historians of economic thought, economic historians, and those with an interest in public finance.

Takuo Dome is Professor in the History of Economic Thought at Osaka University, Japan.

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Preface

This book examines the history of the efforts of Enlightened and Victorian British political economists to address fiscal problems. It covers the period from the publication of Sir James Steuart's *Inquiry into the Principles of Political Oeconomy* in 1767, to John Stuart Mill's death in 1873. Besides these two authors, Adam Smith, Jeremy Bentham, Thomas Robert Malthus, David Ricardo, and John Ramsay McCulloch will be discussed. All seven authors wrestled with the problem raised by David Hume – how to found general principles of political economy which could handle the issue of public finance. Although seven authors' views on public finance have been examined individually – for example, in Shoup (1960), Hollander (1985: 858–80), and O'Brien (1970: 229–70) – a full-scale comparative study has hitherto not been made, with an exception of O'Brien (1975: 241–70).

Some of the authors – typically Smith and Ricardo – have often been referred to as 'laissez-faire economists'. However, in contrast to the general impression created by such a label, they did not disregard the issue of public finance. Moreover, Smith's and Ricardo's attitudes to policy were quite different. In contrast, Malthus – often labelled as an 'interventionist' – did not treat public finance as a separate topic, although he regarded this issue as important. In fact, all seven authors considered public finance as one of the main elements of their political economy. Thus, the traditional laissez-faire/interventionist dichotomy is neither a useful measure of the importance our authors attached to the issue of public finance, nor a sufficient explanation of the differences between their opinions.

This book is distinct from ordinary books on the history of economic thought in giving as much weight to Steuart, Bentham, and McCulloch as to Smith, Ricardo, Malthus, and Mill. Steuart is usually excluded from the group of 'classical economists', because he understood neither the market mechanism nor the theory of surplus value. Steuart has often been called – contemptuously – 'the last mercantilist'. In contrast, in this book Steuart will be treated as the first author who integrated public finance into a systematic account of political economy.

Bentham's views of public finance have not been paid a great attention either by historians of economic thought or Bentham scholars, although Werner Stark (1952–4) edited his writings on public finance almost fifty years ago. Bentham planned to include principles of political economy and public finance in his complete system of legislation. His ideas on public finance were very original, and influenced John Stuart Mill. In fact, Mill can be seen as synthesizing Bentham's principles of public finance with Ricardian political economy. Bentham is an important figure in our theme, and deserves his own chapter.

Finally, despite Denis O'Brien's comprehensive book (O'Brien 1970), McCulloch has not yet been freed from the misleading image of him as 'the vulgar Ricardian'. At least, he has been treated as less important than Ricardo. However, McCulloch was the most informed about public finance of the eighteenth and nineteenth century political economists. On the basis of ample data, McCulloch proposed more practical means of public finance than Ricardo. As a systematic, and at the same time realistic thinker, McCulloch was closer to Smith and Hume.

One of the fruits of viewing the thought of the 'classical economists' from the perspective of public finance rather than that of pure theory, then, is that a different range of thinkers falls to be considered, and a different weighting is given to the material discussed.

The first draft of this book was written in 2000–1 when I visited the Bentham Project at University College London. Professor Fred Rosen and Dr Philip Schofield afforded every facility for my research in the UK. I am also grateful to Osaka University and the Japanese Ministry of Education, Culture, Sports, Science and Technology for the research grant. The chapters on Bentham and Mill are greatly influenced by comments and questions raised by the members of the Bentham Project and those attending the Bentham Seminars. In particular, Dr Luke O'Sullivan assisted me by correcting the English, as well as giving useful suggestions. Special thanks are due to Professors Denis O'Brien and Donald Winch, who read every chapter and made a number of important comments, which helped me to complete this book. I wish also to thank the anonymous referees of *Routledge Studies in the History of Economics* for their useful comments on an early draft of this book. All these acknowledgements never mean that those to whom I owe a debt are responsible for the arguments in this book. Any remaining errors are my own.

This book uses my articles by permission of *Cambridge Journal of Economics, History of Political Economy* and *Utilitas*. Chapter 2 is based on Dome (2001), and Chapter 3, Section 3.3.2 develops the argument in Dome (1998). Chapter 4, Section 4.2 and Chapter 8, Sections 8.3 and 8.4 use Dome (1999). Chapter 5 draws on Dome (1997). Finally, Chapter 6 uses ideas in Dome (1992) and Dome (2000).

1 Introduction

1.1 Hume's legacy

In *Political Discourses* (1752), David Hume declared that since the Glorious Revolution, the new government – which supported the Hanoverian succession to the throne – had promoted commerce and manufactures, as well as political liberty. Hume believed that the growth of commerce and manufactures would refine the people's sense of luxury, and that such refinement would give them an incentive to increase the surplus of the land.[1] National wealth had increased and spread among the people under the new government.

However, in order to support the Hanoverian succession, and maintain the balance of power in Europe, Britain fought too many wars – for example, the War of the Spanish Succession (1702–13) and the War of the Austrian Succession (1740–8). The new, weak government could not impose a lump-sum tax on its subjects in order to finance the wars. Consequently, it resorted to a new system of funding, namely, long-term loans. Because of the 'Financial Revolution',[2] Britain was able to face her giant rival – France. Furthermore, the new system of funding influenced British political stability and social structure, as well as economic performance.

In the essay 'Of Public Credit', Hume explained the economic evils of public debt. It would: increase prices and expel specie from circulation; increase taxes, and consequently increase the price of labour or oppress the poor; transfer a part of the national income to foreigners; and increase the number of stockholders – idle people. These evils would impede the growth of national wealth.

However, to Hume, the political evils of the public debt were more serious than the economic evils.[3] An increase in public debt would increase the numbers and the power of the moneyed interest:

> who have no connexions with the state, who can enjoy their revenue in any part of the globe in which they chuse to reside, who will naturally bury themselves in the capital or in great cities, and who will sink into the lethargy of a stupid and pampered luxury, without spirit, ambition, or enjoyment.
>
> (Hume 1987 [1752]: 357–8)

Public debt would impoverish the several ranks of taxpayers – particularly the landlords – who formed 'a kind of independent magistracy in a state, instituted by the hand of nature' (Hume 1987 [1752]: 358). The confrontation between the moneyed interest and the landlords would throw the system of government into confusion, and the triumph of the former would finally produce a despotism.[4]

A political threat to the diplomatic sovereignty of Britain would be more serious than confusion in the domestic government. Hume described three possibilities with respect to public credit. First, public credit would '*die of the doctor*' (Hume 1987 [1752]: 361; emphasis in original). If the nation became heartily sick of its debts, the government would attempt visionary schemes of redemption – for example, a deliberate inflation, a tax on the interest of public debt, and a forced reduction of the rate of interest. These attempts would immediately destroy public credit.

Hume also thought that Archibald Hutcheson's scheme of a capital levy (a lump-sum tax on property) would produce 'the death by the doctor'. Such a scheme was neither feasible nor equitable:

> [Hutcheson] seems not to have considered, that the laborious poor pay a considerable part of the taxes by their annual consumptions, though they could not advance, at once, a proportional part of the sum required. Not to mention, that property in money and stock in trade might easily be concealed or disguised; and that visible property in lands and houses would really at last answer for the whole: An inequality and oppression, which never would be submitted to.
>
> (Hume 1987 [1752]: 361)[5]

Second, when urgent expenditure – typically on defence – would be needed in the future, if such expenditure could not be undertaken by public debt, nor financed by taxation, the government would use the fund marked for interest payment: in other words, the government would default. Hume called this case 'the *natural death* of public credit' (Hume 1987 [1752]: 363; emphasis in original), stating that it would not be long before public credit would revive in as flourishing a condition as before. In fact, French public credit revived soon after the crash of John Law's scheme. Thus, the 'natural death' of public credit would not produce its perpetual death, nor the death of the polity and economy. However, this statement did not mean that Hume was optimistic about national bankruptcy. Default by the government was an obvious breach of the justice and good faith on which a commercial society had to be founded. The optimistic-looking statement rather demonstrated his cynical view of the foolishness of the majority of mankind: 'Mankind are, in all ages, caught by the same baits: The same tricks, played over and over again, still trepan them' (Hume 1987 [1752]: 363).

The 'death by the doctor' and the 'natural death' were cases in which the nation would destroy public credit. However, the third and the worst case, in which public credit would destroy the nation, Hume called 'the *violent death* of our public credit' (Hume 1987 [1752]: 365; emphasis in original). If the monarch had been absolute, he could have recourse to the 'death of public credit by the doctor' or the 'natural death'. Millions of people would be saved by the sacrifice of thousands of public creditors. In fact, however, popular government in Britain would not be able to resort to such violent measures. The government would attempt to maintain public credit and conceal its crisis from its subjects and neighbouring countries. Forced retrenchment would be necessary, and this would influence British attitudes towards the balance of power in Europe. Hume argued that 'our children, weary of the struggle, and fettered with incumbrances, may sit down secure, and see their neighbours oppressed and conquered; till, at last, they themselves and their creditors lie both at the mercy of the conqueror' (Hume 1987 [1752]: 365). Thus, in the future, because of the public debt, British sovereignty would be violated by a foreign enemy.

Hume argued that the 'death by the doctor', the 'natural death', and the 'violent death' seem to be the events 'which are not very remote, and which reason foresees as clearly almost she can do any thing that lies in the womb of time' (Hume 1987 [1752]: 365). Although all these deaths of public credit would be disastrous to the development of liberal and commercial society, Hume did not put forward an efficient system of taxation which could avoid national bankruptcy. In the essay 'Of Taxes' – which was placed before 'Of Public Credit' – Hume demonstrated that all arbitrary taxes were inconsistent with liberal and commercial society:

> the most pernicious of all taxes are the arbitrary. They are commonly converted, by their management, into punishments on industry; and also, by their unavoidable inequality, are more grievous, than by the real burden which they impose. It is surprising, therefore, to see them have place among any civilized people.
>
> (Hume 1987 [1752]: 345–6)

To Hume, taxes on consumption – particularly taxes on luxuries – were not arbitrary, because they were paid voluntarily, and fell equally on rich consumers – typically the landlords and the moneyed interest:

> The best taxes are those which are levied upon consumptions, especially those of luxury; because such taxes are least felt by the people. They seem to be, in some measure, voluntary; since a man may chuse how far he will use the commodity which is taxed: They are paid gradually and insensibly: They naturally produce sobriety and frugality, if judiciously imposed: And being confounded with the natural price of the commodity, they are scarcely perceived by the consumers. Their only disadvantage is, that they are expensive in the levying.
>
> (Hume 1987 [1752]: 345)

Hume did not agree with John Locke's arguments that all taxes – including taxes on luxuries – would finally fall on the rent of land, and that all taxes should be commutated into a single tax on rent.[6] Hume wrote:

> There is a prevailing opinion, that all taxes, however levied, fall upon the land at last. Such an opinion may be useful in Britain, by checking the landed gentlemen, in whose hands our legislature is chiefly lodged, and making them preserve great regard for trade and industry. But I must confess, that this principle, tho' first advanced by a celebrated writer [i.e. Locke], has so little appearance of reason, that, were it not for his authority, it had never been received by anybody.
>
> (Hume 1987 [1752]: 636)[7]

Hume thought that merchants could not easily raise the price of the commodity taxed, because domestic prices were limited by prices in foreign markets. Even if merchants were able to raise the price, it would not always fall on landlords alone. If the commodity taxed was a luxury good, consumers would have to pay the tax. Even if the commodity taxed was a necessary good consumed by labourers, it would produce a 'stimulation effect', as long as the increase in the price was moderate. Labourers would work harder in order to compensate for the reduction in their consumption by the tax: wages would not rise in this case.[8] Consequently, a tax on a commodity would fall on merchants, rich consumers or labourers, depending on whether prices and wages could rise. Hume argued 'why the landed gentleman should be the victim of the whole, and should not be able to defend himself, as well as others are, I cannot readily imagine' (Hume 1987 [1752]: 347). Thus, a single tax on the rent of land was an arbitrary tax.

Whereas taxes on luxuries were voluntary and checked by markets, taxes on property were compulsory and apt to be arbitrary: 'Taxes upon possessions are levied without expence; but have every other disadvantage' (Hume 1987 [1752]: 345). Even a direct tax imposed equally on all kinds of property could be arbitrary. Whereas landlords could not hide their land from inspectors, the moneyed interest could hide their property more easily. They could also export it to foreign countries in order to escape direct taxes.

Taxes on luxuries alone were consistent with liberal and commercial society. However, such taxes would not produce sufficient revenue to prevent the three kinds of death of public credit. In order to prevent these deaths, the government would have to impose direct taxes which were apt to be arbitrary. Hume acknowledged that '[m]ost states ... are obliged to have recourse to [direct taxes], in order to supply the deficiencies of [indirect taxes]' (Hume 1987 [1752]: 345), and exclaimed, 'What a loss to the public ... that we must have recourse to the more grievous method of levying taxes!' (Hume 1987 [1752]: 356). Hume's essays on public credit and taxes exposed an incompatibility between public debt and the continuation of liberal and commercial society.[9]

Thus, Hume left to future generations the problem of how to establish a system of public finance compatible with liberal and commercial society. This problem could be called 'Hume's legacy'. Those who were interested in the growth of liberal and commercial society had to consider (1) management of government expenditure, (2) a fair and efficient system of taxation, and (3) debt management. Since William Petty, these topics had often been argued over by political arithmeticians and pamphleteers.[10] However, the question had to be answered not by fragmentary observations on current issues, but by methodical philosophical argument. Hume had complained:

> [The bulk of mankind] cannot enlarge their view to those universal propositions, which comprehend under them an infinite number of individuals, and include a whole science in a single theorem. Their eye is confounded with such an extensive prospect; and the conclusions, derived from it, even though clearly expressed, seem intricate and obscure. But however intricate they may seem, it is certain, that general principles, if just and sound, must always prevail in the general course of things, though they may fail in particular cases; and it is the chief business of philosophers to regard the general course of things.
>
> (Hume 1987 [1752]: 254)

Every issue – with respect to society, polity, and economy – had to be examined on the basis of general principles. With regard to the issue of public finance, general principles of political economy – namely, a systematic account of the nature and causes of national wealth – would be particularly important, although they had not yet been established. Thus, Hume's legacy was to begin a search for general principles of political economy which could address the problems of public finance anticipated in liberal and commercial society. In fact, all seven authors studied here – Steuart, Smith, Bentham, Malthus, Ricardo, McCulloch, and J. S. Mill – participated in this search.

1.2 Periodization

Before entering into the examination of each author's political economy of public finance, let us briefly review British fiscal conditions in the period in which our authors wrote. The period – 1767–1873 – can be divided into three shorter periods.[11]

1.2.1 Period I (1767–92)

In the first period, the nominal amount of public debt increased because of the Seven Years War (1756–63) and the American War of Independence (1775–83), although the increase was not as steep as in the following

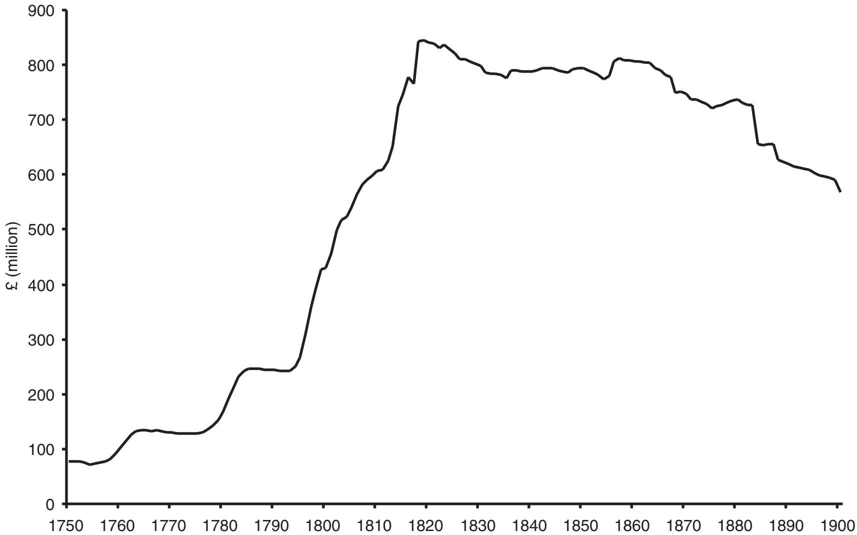

Figure 1.1 The nominal amount of public debt.

Source: Mitchell (1988: 600–2).

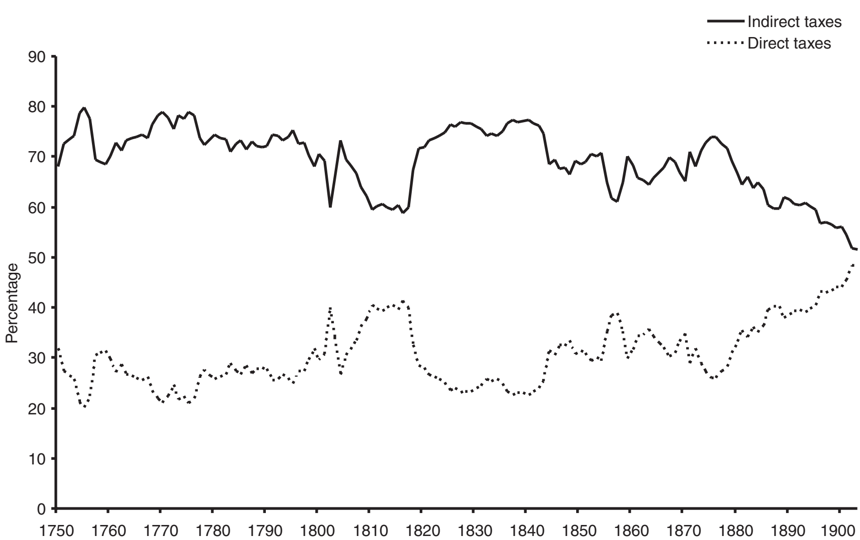

Figure 1.2 The structure of government revenue.

Source: Mitchell (1988: 576–7, 581–2).

Note

Indirect taxes include excises and customs; direct taxes include land and assessed taxes, income tax, stamps and death duties.

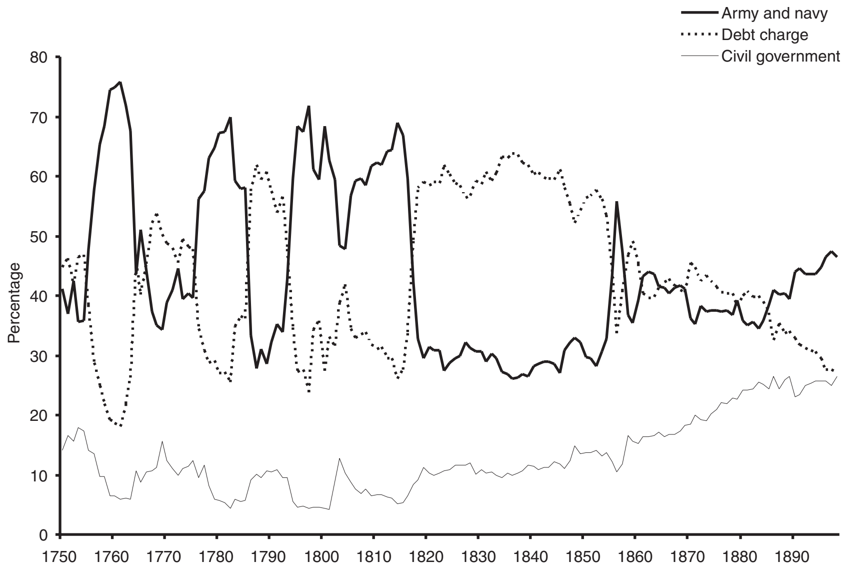

Figure 1.3 The structure of government expenditure.

Source: Mitchell (1988: 579–80, 587–8).

period (see Figure 1.1). Victory in the Seven Years War wiped out French political dominance in North America and India. However, the financial condition of the government worsened. The British government insisted on exercising powers of taxation over the American colonies, which provoked the colonists into a war of independence. Consequently, Britain had to spend more, and public debt increased to a level that not only made its complete redemption appear almost impossible, but also created fears of a public bankruptcy (Hargreaves 1966 [1930]: 60).

However, a public bankruptcy did not occur, because the increase in long-term loans was supported by a shift from land and assessed taxes to wide-ranging excises. In fact, the government's main sources of revenue in this period were excises and custom duties (see Figure 1.2). Expenditure on civil government – for example, salaries of civil servants and public services – as a percentage of total government expenditure was much lower than those on military services and a debt charge (see Figure 1.3). Public services – such as education, health, sanitation, and poor relief – were usually undertaken by local authorities. Because it left these services to local authorities, the central government remained free to concentrate on war and imperialism. Because the public debt was issued in order to finance war, a debt charge could be regarded as a cost relating to military affairs. Thus, by the end of this period, Britain had established ‘the fiscal-military state’, characterized by accumulation of public debt, reliance on indirect taxes, and spending on military affairs.[12]

Sir James Steuart (1712–80) and Adam Smith (1723–90) both proposed general principles of political economy in this period. Steuart’s *Inquiry into the Principles of Political Oeconomy* (1767) and Smith’s *Inquiry into the Nature and Causes of the Wealth of Nations* (six editions: 1776, 1778, 1784, 1786, 1789, and 1791) were directly influenced by Hume’s *Political Discourses*. Faced with a continuous increase in war expenditure, imperial expansion and public debt, Steuart and Smith could not avoid addressing Hume’s problem, the danger of public bankruptcy. In particular, Smith had to take into account the revolt of the American colonies which occurred just before completing *Wealth of Nations*. In the concluding parts of their volumes, Steuart and Smith discussed how to manage government expenditure and public debt, and establish a fair and efficient system of taxation.[13]

1.2.2 Period II (1793–1841)

Because of the Revolutionary and Napoleonic Wars (1793–1815), public debt increased dramatically, from about £240 million to about £840 million (see Figure 1.1). The latter figure accounted for more than twice the value of Britain’s national product at the time. During these wars, taxes, direct and indirect, were raised. In 1797, in order to prevent a run on the banking system, the government suspended specie convertibility of Bank of England notes. The suspension continued until 1821, and Bank of England notes circulated only on the basis of their historical credit. In 1798, William Pitt increased assessed taxes, and made the land tax perpetual at the 4 shilling rate. However, these policies did not seem to address the problem. In the following year, Pitt introduced an income tax. A number of arguments over the method of taxation took place inside and outside Parliament. The two most important issues were graduation and differentiation.[14]

In Pitt’s income tax, a rate of 10 per cent was uniformly imposed on incomes over £200. Incomes under £60 were completely exempted from the tax. Various tax rates under 10 per cent were applied to incomes between £60 and £200. The tax used a self-assessment system, which unsurprisingly resulted in a number of false declarations. Thus, in 1803, in order to introduce the system of ‘stoppage at source’, incomes were grouped under five schedules. Rents of land and buildings belonged to Schedule A; B covered farming profits; C, interest of public debt; D, various forms of profits and interest, notably professional incomes; and E, salaries of government employees and pensions. Despite these reforms, income tax continued to be unpopular. In particular, its inquisitorial nature provoked resentment. After the wars, the tax was abolished, although the government would have preferred to maintain it in order to reduce the outstanding public debt.

The government attempted to reduce public debt by a sinking fund, using the fixed-transfer system. This was a system in which a fixed amount of money was regularly transferred to the sinking fund, regardless of whether the nation's fiscal condition was one of surplus or deficit. However, the abolition of the income tax made it impossible for this measure to succeed. The government had to borrow in order to maintain the sinking fund. In 1829, the Finance Committee decided to abolish the fixed-transfer system, and reduce the public debt only if a budget surplus permitted. This policy was meant to maintain budgetary equilibrium in order to avoid recourse to fresh borrowing (Hargreaves 1966 [1930]: 156). Consequently, the nominal amount of outstanding public debt was not drastically reduced (see Figure 1.1).

Lord Liverpool's administration made considerable efforts at retrenchment. However, it was reliant on customs and excises for over 70 per cent of its revenue (see Figure 1.2), and more than half of government expenditure now went on servicing debt charges (see Figure 1.3). Although in the 1820s Frederick John Robinson, Chancellor of the Exchequer, and William Huskisson, President of the Board of Trade, carried out tariff reforms, there remained a number of oppressive and regressive indirect taxes.[15] Lower- and middle-class taxpayers thought it unfair that money was being transferred to the public creditors through indirect taxes.

In 1830, Henry Parnell – Chairman of the Finance Committee in 1829 – wrote *On Financial Reform*. The book argued that public debt had to be restricted, and oppressive indirect taxes abolished, because they would prevent economic growth. In order to effect these policies, Parnell proposed reintroducing an income tax (Parnell 1968 [1831]: 260–4). However, income tax remained politically unpopular because of its inquisitorial nature. Moreover, it was considered a war tax, not to be used in peacetime. Reintroduction of the income tax might permit the government to neglect retrenchment and reduction of excises and customs. Consequently, Parnell's proposals were not widely accepted, although his book was influential on subsequent writers.[16]

Thus, because of the fiscal confusion caused by the Revolutionary and Napoleonic Wars, popular trust in the state and willingness to consent to taxation – both of which had supported government structures in eighteenth-century Britain – were greatly reduced. As Daunton (2001: 32–57) argues, the limits of 'the fiscal-military state' were revealed by the end of this period.

Jeremy Bentham (1748–1832), Thomas Robert Malthus (1766–1834), and David Ricardo (1772–1823) were all active in this period. Between 1794 and 1800, Bentham wrote several plans for public finance, although they were not published. Bentham's vision of the general principles of political economy was outlined in *Manual of Political Economy* (1793–5) and *Institute of Political Economy* (1801–4). Although Malthus did not discuss public finance as an independent topic, his opinions on this subject were set out in the second and subsequent editions of *An Essay on the Principle of Population* (five editions: 1803, 1806, 1807, 1817, and 1826), as well as in his *Principles of Political Economy* (two editions: 1820 and 1832). Ricardo devoted almost one-third of his *Principles of Political Economy, and Taxation* (three editions: 1817, 1819, and 1821) to the subject of taxation. Ricardo also contributed an article on the 'Funding system' to the supplement to the fourth edition of *The Encyclopaedia Britannica* (1820).

To these three authors, the deteriorating fiscal condition of Britain might have suggested that Hume's prophecy was coming true. In fact, it was a difficult time to be putting forward a consistent plan of public finance. During the war, they had to face the dilemma of the absolute necessity of government expenditure and the harmful effects of taxes and public debt. They also had to consider the effects of public finance on an unstable price situation. After the war, Malthus and Ricardo were confronted with another dilemma – a simultaneous reduction of taxes and the public debt. They had to address the role of this problem in the post-war depression.

1.2.3 Period III (1842–73)

A new era in the British fiscal system began in 1842 when Robert Peel reintroduced the income tax. Peel justified the tax as the only way of compensating for the budget deficit, and of carrying out vital tariff reforms. The new income tax followed the system of five schedules described above. A uniform rate of about three per cent was imposed on all kinds of incomes over £150. Subsequently, the rate of tax, as well as the tax exemption limit, changed frequently. Although the income tax was widely expected to be only a temporary measure when first reintroduced, it was never abolished again. Of course, its reintroduction provoked a number of complaints and arguments. Most of them concentrated, as before, on graduation and differentiation, although neither was institutionalized until early in the twentieth century.[17]

This period is usually characterized as the time at which free trade was at the height of its influence, symbolized by the repeal of the Corn Laws in 1846 and of the Navigation Acts in 1849. In fact, through four tariff reforms by Peel and William Gladstone between 1842 and 1860, the number of articles subject to customs duties was reduced from more than 1,000 to 48. A number of excise duties were also reduced or abolished. Although excises and custom duties still accounted for a large percentage of government revenue than other taxes – land and assessed taxes, income tax, stamps and death duties – the gap between these two percentages narrowed, and finally disappeared early in the twentieth century (see

Figure 1.2). Thus, this period can be said to be a period of transition to a balance of direct and indirect taxes.

Retrenchment was an ongoing process, in spite of the reintroduction of income tax. In fact, the Crimean War (1853–6) was the only costly war. After the war, public debt was gradually reduced (see Figure 1.1). Economic growth diminished the real burden of public debt, which amounted to only 70 per cent of the net national income in 1870, having stood as high as 180 per cent in 1842 (Mitchell 1988: 601–2, 831–2). Public debt no longer carried the threat of national bankruptcy. Indeed, it was now regarded as a symbol of liberty, probity, and prosperity in British commerce (Daunton 2001: 110–21). Moreover, although net government revenue in 1842 – £48.2 million – increased to £67.5 million in 1870, it amounted to just 6 per cent of net national income in 1870, whereas it had stood at 11 per cent in 1842 (Mitchell 1988: 581–2). Thus the national tax burden and, just as importantly, the perception of an unfair tax burden also diminished.

The reduction of public debt enabled central government to spend more on public services.[18] In fact, after 1842, expenditure on civil government as a percentage of total government expenditure increased, although its level was lower than expenditure on military services and debt charges (see Figure 1.3). Although Britain was still a long way from the twentieth-century welfare state, the way towards it was prepared.

This period, then, is characterized by the introduction of a permanent income tax, tariff reforms, retrenchment, debt redemption, economic growth, and expansion of public services. During these years, the legitimacy of and consent to taxation was re-established, but on a new basis. An integral part of this process was the transformation of the British fiscal-military state into what Daunton (2001: 135) calls 'the civilian-military state'.[19]

Amongst the most important writers active in this period were John Ramsay McCulloch (1789–1864) and John Stuart Mill (1806–73), both of whom had already published various early writings in period II. McCulloch and Mill began from Ricardian political economy, but diverged from it as time passed. As will be shown in the last two chapters, the directions they took were diametrically opposed. Whereas McCulloch abandoned the concept of class conflict which Ricardian political economy implied, Mill used this concept in order to support a vision of a more equitable society. McCulloch was the best informed political economist in the nineteenth century about public finance. McCulloch's main work on this subject was *Treatise on the Principles and Practical Influence of Taxation and the Funding System* (three editions: 1845, 1852, and 1863), in effect a supplementary volume to his *Principles of Political Economy* (five editions: 1825, 1830, 1843, 1849, and 1864). Besides this, McCulloch devoted a number of writings throughout his life to the issue of public finance. Mill also wrote a number of articles on tax reform after the 1830s. His

Principles of Political Economy (seven editions: 1848, 1849, 1852, 1857, 1862, 1865, and 1871) included chapters on taxation and public debt. Mill was involved in the Select Committees on Income and Property Tax in 1852 and 1861, and referred to land tax reform in the Land Tenure Reform Association which he chaired in the 1870s.

Because of economic growth and a reduction of public debt, McCulloch and Mill were no longer exposed to a fear of state bankruptcy. However, they had to consider how to develop a peacetime system of public finance which was efficient, fair, and consistent with economic growth. Thus, public finance remained an important subject which they had to handle. Moreover, it must be remembered that in this period inequality in income distribution increased,[20] as did labourers' discontent with such inequality. McCulloch and Mill had to consider whether it would be reasonable to use taxation in order to redistribute income or diffuse property more widely.

Thus, each of our seven authors faced different social, economic, and fiscal conditions. Yet at the same time they all had to struggle with Hume's legacy – the mission to establish the political economy of public finance. The following seven chapters examine each author individually, and their opinions are then compared in the concluding chapter.

Notes

1 Hume argued: 'the greatness of the sovereign and the happiness of the state are, in a great measure, united with regard to trade and manufactures. It is a violent method, and in most cases impracticable, to oblige the labourer to toil, in order to raise from the land more than what subsists himself and family. Furnish him with manufactures and commodities, and he will do it of himself' (Hume 1987 [1752]: 262).

2 The term 'Financial Revolution' was coined by Dickson (1993 [1967]). It indicates the rise of the system of long-term government borrowing in the six decades before the Seven Years War. Dickson (1993 [1967]: 12) argues: 'Its effects on the country's life, social attitudes, and historical development resemble on a smaller scale those of the Industrial Revolution which followed it, and which it arguably helped to make possible'.

3 Winch (1998: 13) writes of Hume's political stance with respect to the public debt: 'When diagnosing the nature of political parties, Hume held that the "genuine offspring" of Britain's "mixed" constitution was the division, based on principle and interest, between Court and Country parties, with the latter being opposed to foreign wars, political corruption, and an idle monied interest. Whereas Hume adopted a hard-headed Court view on the necessity of "influence", even "corruption", in managing parliament, on public debt his opinions veered decidedly in a Country decision'. See also Winch (1978: 126).

4 For the debate in the first half of the eighteenth century concerning the rise of the moneyed interest, see Dickson (1993 [1967]: 15–35).

5 In the nineteenth century, Ricardo revived the capital levy scheme. However, he did not solve the problems Hume raised. See Section 6.4 of Chapter 6 (pages 131–8).

6 In the pamphlet *Some Consideration of the Consequences of the Lowering of Interest, and Raising the Value of Money* (1691), Locke argued: 'It is in vain in

a Country whose great Fund is Land, to hope to lay the publick charge of the Government on any thing else; there at last it will terminate. The Merchant (do what you can) will not bear it, the Labourer cannot, and therefore the Landholder must: And whether he were best do it, by laying it directly, where it will at last settle, or by letting it come to him by the sinking of his Rents, which when they are once fallen every one knows are not easily raised again, let him consider' (Locke 1991 [1691]: 278).

7 In 1766, Hume entered into controversy with Turgot, who supported a single tax on rent on the basis of the Physiocratic assumption that land alone furnished the net product. Hume believed that the net product was shared between the landlords and the moneyed interest, and that taxes should be paid equally by these two classes. He wrote to Turgot: 'I beg you also to consider, that, besides the Proprietors of Land and the labouring Poor, there is in every civilised Community a very large and a very opulent Body who employ their Stocks in Commerce and who enjoy a great Revenue from their giving Labour to the poorer sort . . . Now it is very just, that these should pay for the Support of the Community, which can only be where Taxes are lay'd on Consumptions' (Rotwein 1955: 209). In the 1770 edition of *Political Discourses*, the above passage was altered as follows: 'It is an opinion, zealously promoted by some political writers, that, since all taxes, as they pretend, fall ultimately upon land, it were better to lay them originally there, and abolish every duty upon consumptions. But it is denied, that all taxes fall ultimately upon land' (Hume 1987 [1752]: 346). Thus, Hume consistently criticized Locke's and the Physiocrats' single-tax scheme.

8 Hume argued: 'the poor encrease their industry, perform more work, and live as well as before, without demanding more for their labour. Where taxes are moderate, are laid on gradually, and affect not the necessaries of life, this consequence naturally follows' (Hume 1987 [1752]: 343). Hume's idea of tax stimulation was taken up by later writers, particularly McCulloch. See Section 7.3 of Chapter 7 (pages 147–8).

9 Concerning Hume's pessimism, Forbes (1975: 176) argues that 'Hume saw the national debt threatening the national existence, and therefore all ranks of men, whatever he may have thought of some of them', but Robertson (1983: 155) argues: 'although Hume was certainly alarmed, it is important to recognize that he did not present public credit as spelling the inevitable doom of modern commercial societies. Throughout the essay his argument was strictly conditional: he acknowledged that its premises were suppositions, and stated his conclusions in the form of tendencies. If his language was unusually vehement, it was precisely because, even in the absence of extraordinary circumstances, the danger could still be averted'.

10 For example, see Petty (1997 [1662]), Davenant (1695) and (1967 [1698]), Decker (1999 [1748]), and Fauquier (1999 [1757]).

11 For a comprehensive history of British public finance during these three periods, see, for example Buxton (1966 [1888], vol. 1: 1–353 and vol. 2: 1–161), and Dowell (1965, vol. 2: 144–386).

12 The term 'fiscal-military state' was coined by Brewer (1989). The emergence of 'the fiscal-military state' can be regarded as a different expression for Dickson's 'financial revolution'. For the history of public finance in eighteenth-century Britain from the viewpoint of the fiscal-military state, see Mathias and O'Brien (1976: 633–40), O'Brien (1988: 1–32), and Daunton (1995: 507–32).

13 For the debates on public finance in this period, see Shehab (1953: 9–45), and Kennedy (1964 [1913]: 113–79).

14 For primary literature on these issues see, for example, Auckland (1999 [1799]), Frend (1999 [1799]), Liverpool (1999 [1799]), and Beeke (1999 [1800]).

For secondary literature, see Seligman (1970 [1914]: 57–114), Shehab (1953: 46–69), Sabine (1966: 26–59), and Daunton (2001: 32–57).

15 For Robinson's and Huskisson's tariff reforms, see Dowell (1965, vol. 2: 275–87).

16 For Parnell's influence see, for example, Shehab (1953: 70–85), Dowell (1965, vol. 2: 288–306), and O'Brien (1999, vol. 4: vii–xi).

17 For the debates on the income tax see, for example, Seligman (1970 [1914]: 116–66), Shehab (1953: 86–172), Sabine (1966: 60–108), and Daunton (2001: 77–108). O'Brien (1999, vol. 5, vol. 6, and vol. 7) reprints main primary literature on the income tax after 1842, including works by David Buchanan, Charles Babbage, John Gellibrand Hubbard, William Farr, and S. Morton Peto, as well as McCulloch and Mill.

18 For the relationship between central government and local authorities with respect to public services and investment, see Daunton (2001: 256–301).

19 Daunton (2001: 26–7, 373–4 and 378–9) emphasizes that because the fiscal constitution was successfully established by Peel and Gladstone, Britain could enter the First World War with an effective national tax regime.

20 For example, see Soltow (1968: 17–29), Williamson (1985: 52–73), and Ekelund and Walker (1996: 567–71).

2 Sir James Steuart[1]

2.1 Introduction

Sir James Steuart's *Inquiry into the Principles of Political Oeconomy* (1767; henceforth *Principles*) was probably the first book in Britain that argued for a theory of public finance on the basis of a consistent system of political economy. Steuart wrote the book in order to suggest useful hints to a statesman, as well as to 'influence the spirit of those he governs' (Steuart 1998 [1767], vol. 1: 13). Steuart began to write Book 4, 'Of Credit and Debts', and Book 5, 'Of Taxes, and of The Proper Application of Their Amount' of the *Principles* after returning to Britain from exile in 1763, immediately after the Seven Years War.[2] In Chapter 12 of Book 5 – the last substantive chapter of the *Principles* – Steuart demonstrated the following proposal:

> Every one who has written concerning taxes has endeavoured to contract [i.e. reduce] the object of them as much as possible: more, I imagine with a view to ease the public than the people. I have followed another course. I have been for multiplying the objects of taxation as much as possible, and for making them more in proportion to expence than to property or income. But that I may conform myself in some measure to the ideas of those who have examined the same subject, I shall propose a tax, which would fill up the place of every other; and could it be levied, would be the best perhaps ever thought of. It is a tax, at so much per cent. upon the sale of every commodity.
>
> (Steuart 1998 [1767], vol. 4: 247)

In fact, Steuart proposed a general sales tax as a replacement for the land tax. Steuart's general sales tax can be credited partly to Charles Davenant, who proposed to finance the War of the Spanish Succession by extending the excise.[3] Concerning Davenant's scheme, Steuart commented that '[i]n his treatise of ways and means, article *excises*, where he is searching for expedients to provide money for the war, he plainly shews a thorough knowledge of this imposition' (Steuart 1998 [1767], vol. 4: 20), and that difficulties in excise 'engaged Davenant to propose having recourse to the land-property and poll-taxes, for raising, within the year, the sums required for carrying on the war' (Steuart 1998 [1767], vol. 4: 20).[4]

Steuart's proposal can also be regarded as following Robert Walpole's tax policies early in the 1730s. In 1732, in order to reduce the land tax, the salt tax was revived, which had been abolished in 1730. Moreover, in 1733, Walpole proposed a scheme of introducing the warehouse system for the importation of tobacco and wine. This scheme failed, because it was regarded as a preparatory measure which would be followed by the imposition of the excise on all the necessities of life.[5] With reference to the failure of the scheme, Steuart commented:

> The scheme of a general excise was pushed with too much vivacity, was made a matter of party, was ill-timed, and people nowise prepared for it; hence it will be the more difficult to bring about at another time, without the greatest precautions.
>
> (Steuart 1998 [1767], vol. 1: 30)

Despite the failure of the scheme, Steuart thought that 'Sir Robert Walpole discovered new principles of taxation; he extended the plan of public credit, and reduced the application of it to a science' (Steuart 1998 [1767], vol. 1: 85).

Steuart also followed Hume in preferring indirect taxes to direct taxes, although Steuart did not refer to Hume directly. Moreover, as will be shown below, Steuart's proposal of a general sales tax – as well as his demand-creating theory of public debt – could be regarded as an answer to Hume's pessimistic prediction with respect to public credit.

Thus, Steuart's proposal of a general sales tax located him within the long tradition of consumption-tax supporters.[6] However, in contrast to his precursors, Steuart attempted to derive his policy proposals from a consistent system of political economy. In the *Principles*, Steuart examined the topics of population, agriculture, trade, industry, money, coin, interest, circulation, banks, exchange, public credit, and taxes, concluding that '[t]he principles deduced from all these topics, appear tolerably consistent; and the whole is a train of reasoning, through which I have adhered to the connection of subjects as faithfully as I could' (Steuart 1998 [1767], vol. 1: 7).

This chapter demonstrates that Steuart's proposal of a general sales tax can be deduced consistently from his system of political economy. For this purpose, I will reconstruct Steuart's system of political economy, showing the logical relationship between his theory of public debt (Part 4 of Book 4 in the *Principles*) and his theory of taxation (Book 5). This chapter will also show that Steuart's macroeconomic theory of taxation and public debt is based on, and consistent with, his theory of tax incidence. Since John Maynard Keynes's reappraisal of his precursors' ideas on effectual demand, many scholars have attempted to rehabilitate Steuart.[7] However, Steuart's theory of public finance has rarely been examined, aside from treatments by Stettner (1945), Sen (1957), and Yang (1994). The reasons why Steuart concluded with the recommendation of a general sales tax have not been clarified.[8] In order to rehabilitate Steuart's political economy as a logical system, his theory of public finance has to be reconstructed in a consistent form.

2.2 Steuart's system

Steuart indicated that trade would develop in three stages – 'infant trade', 'foreign trade', and 'inland trade'. Infant trade 'has for its object the supplying the necessities of the inhabitants of a country' (Steuart 1998 [1767], vol. 1: 317). According to Steuart, a country's population could be divided into two groups: 'the farmers', who produced food; and 'the free hands', who lived on surplus food provided by farmers. A manufacturing class – a sub-class of the free hands – supplied non-food commodities to the farmers, as well as to other classes of free hands.[9] In infant trade, food and non-food commodities were exchanged only between people in that country. The ruling principle which the government had to adopt at this stage was to encourage domestic manufacture:

> by extending the home-consumption of them; by excluding all competition with strangers; by permitting the rise of profits, so far as to promote dexterity and emulation in invention and improvement; by relieving the industrious of their work, as often as demand for it falls short.
>
> (Steuart 1998 [1767], vol. 1: 320)

Domestic manufactures would be exported, when they became able to compete with foreign manufactures. This was the stage of foreign trade at which the government had to 'encourage frugality' and 'fix the lowest standard of prices possible' (Steuart 1998 [1767], vol. 1: 321). Through such policies, a trade surplus would be produced, and foreign currencies would flow into circulation. Consequently, domestic manufactures would expand further.

However, Steuart did not believe that this prosperous period would last for long. Because of population growth, the price of food would rise, and consequently the price of labour would increase. Moreover, as trade and industry developed, the degree and range of monopolies would become greater: prices would be kept high. These factors would raise the price of exports, weaken their competitiveness, and consequently make the balance of trade unfavourable. Furthermore, as the custom of luxury spread, the import of foreign commodities would increase. Wars – inevitable at the stage of foreign trade – would also increase imports.[10] The balance of trade would finally become negative. Specie would flow out of circulation, and industry would decay. Steuart believed that the government should restrict

– and finally extinguish – foreign trade: 'when a nation, which has enriched herself by a reciprocal commerce in manufactures with other nations, finds the balance of trade turn against her, it is her interest to put a stop to it altogether' (Steuart 1998 [1767], vol. 1: 345).[11] The economy would become closed to foreign trade, and move to the stage of inland trade.

Inland trade was the stage at which domestic manufacture was depressed because of the extinction of favourable foreign trade. A number of manufacturers and labourers would have lost their jobs. In order to recover the national economy, the government had to create effectual demand through government expenditure: 'The public treasure ... may throw [money] out into the most proper channels, and thereby keep that industry alive, which formerly flourished, and depended upon the prosperity of foreign commerce only' (Steuart 1998 [1767], vol. 2: 71). However, government expenditure had to be financed by taxes. Hence, 'taxes become necessary, both for the support of government on the one hand, and, on the other, to serve as an expedient for recalling foreign trade in spite of all the pernicious effects of luxury to extinguish it' (Steuart 1998 [1767], vol. 1: 322).

Steuart's theory of public finance set out in Books 4 and 5 of the *Principles* assumed that the economy had reached the stage of inland trade.[12] In order to avoid the national decline and recover foreign markets, a common domestic market had to be established through public finance policies. In the subsequent discussion, I will assume a closed economy, in which unemployment existed.[13]

The characters involved were landlords, the moneyed interest, the industrious classes and statesmen (government). The industrious classes were composed of farmers, manufacturers and merchants. Landlords rented their land to farmers, receiving rent in return.[14] The moneyed interest – for example, usurers, bankers, and stockholders – lent money to landlords, the industrious classes and the government, receiving interest in return.[15]

Whereas the farmers produced food and raw materials, manufacturers produced necessities of life as well as luxuries. Production of manufactures used agricultural products as raw materials (Steuart 1998 [1767], vol. 4: 146–8). It is unclear whether Steuart thought that agricultural production used manufactures as tools and machines. Farmers, manufacturers, and merchants were self-employed or employed by others. Wages of labour were 'regulated by the demand for the work, and the competition among the workmen to be employed in producing it' (Steuart 1998 [1767], vol. 4: 161). The price of necessities influenced the money wage rate. Although Steuart referred to the labour market, he did not regard capitalistic production – which, through employing labour, regularly produced a surplus, and distributed it between profits of capital and rent of land – as a typical phenomenon of modern commercial society.[16] Commodities produced by farmers and manufacturers were sold – in exchange for money – through merchants to landlords, the moneyed interest and the government as well as to the industrious classes.[17]

Steuart defined money as:

> *any commodity, which purely in itself is of no material use of man for the purposes* [of consumption], *but which acquires such an estimation from his opinion of it, as to become the universal measure of what is called value, and an adequate equivalent for any thing alienable.*
>
> (Steuart 1998 [1767], vol. 1: 51; emphasis in original)

Practically, money was composed of metallic money and convertible paper money. Paper money was issued by 'banks of circulation' on the basis of mortgages they held, as well as metallic money they reserved. Because banks of circulation usually issued paper money over reserved metallic money, they created credit. Steuart called this kind of credit 'private credit' (see Section 2.4.2, page 29). If demand for money exceeded supply, 'solid property' – typically land – would be mortgaged by banks and 'melted down' (i.e. transformed) into paper money, which would flow into circulation. In contrast, if the supply of money became excessive, paper money would return to the banks: consequently, the mortgages they held would diminish. In Steuart's system, the banking system played an important role in balancing the supply of money with demand for it and stabilizing the rate of interest (Steuart 1998 [1767], vol. 3: 165–74 and 188–92).

Steuart did not support Montesquieu's and Hume's opinion that the quantity of money existing in a country would determine the general price level (Steuart 1998 [1767], vol. 2: 72–92). Some portion of money could be hoarded. Moreover, as shown above, the money supply was adjusted to demand for money through the banking system. Steuart believed that the price of commodities was determined by supply and 'effectual demand', defined as people's desires for commodities supported by purchasing power.[18] It was the quantity of money appropriated for purchase – not the existing quantity of money – that determined the general price level.

It must be stressed that Steuart regarded money not only as a means of facilitating exchange, but also as a means of creating an effectual demand for commodities. Because unemployment of labour existed at the stage of inland trade, an increase in effectual demand would increase the production of commodities, creating demand for the work of the industrious classes. Thus, an increase in the money supply did not always raise the general price level, if it increased effectual demand. According to Steuart:

> Increase the money, nothing can be concluded as to prices, because it is not certain that people will increase their expences in proportion to their wealth; and although they should, the moment their additional demand has the effect of producing a sufficient supply, prices will

> return to the old standard. But diminish the quantity of specie *usually employed* in circulation, you both retard this, and hurt the industrious; because we suppose the former quantity exactly sufficient to preserve both in the just proportion to the desires and wants of the inhabitants.
> (Steuart 1998 [1767], vol. 2: 91; emphasis in original)[19]

Whereas landlords, the moneyed interest and the industrious class could act on the basis of their self-interest, governments had to harmonize the whole system in accordance with the public interest. In contrast to Smith, Steuart did not consider that the 'invisible hand' of the free market would naturally produce equilibrium. Steuart stated that 'as the operation of natural causes must destroy this equilibrium, the hand of a statesman becomes constantly necessary to prevent it' (Steuart 1998 [1767], vol. 2: 177).[20] Governments had to participate in the economic system through trade, monetary and fiscal policies. In particular, '[a] statesman should make it his endeavour to employ as many of every class as possible, and when employment fails in the common run of affairs, to contrive new outlets for young people of every denomination' (Steuart 1998 [1767], vol. 1: 83). As part of their fiscal policies, governments issued public debt and imposed taxes, and they spent public revenue on civil servants, wars, subsidies, debt charges, and so on. Public debt was undertaken mainly by the moneyed interest. The moneyed interest could also obtain land by buying directly from landlords or by lending money on land. Landlords could spend money on consumption, improvement of their land, public debt, and the payment of taxes.

Steuart argued that '[*a*] *statesman ought carefully to distinguish between those branches of circulation which operate a vibration in the balance of wealth, and those which do not, in order to regulate the taxes which he may think proper to lay upon his people*' (Steuart 1998 [1767], vol. 2: 63; emphasis in original). Circulation that did not 'operate a vibration in the balance of wealth' referred to an exchange between money and non-money property: for example, an exchange of money and land between the moneyed interest and landlords; and an exchange of money and public debt between the moneyed interest and the government. By contrast, an exchange between money and consumption goods was defined as a circulation that did 'operate a vibration in the balance of wealth'. Steuart thought that the opportunity to impose consumption taxes would most conveniently arise when circulation 'operated a vibration in the balance of wealth', that is when consumption goods were sold.

Consumers were divided into two classes: idle consumers and industrious consumers. People who could not recover indirect taxes on consumption by raising the price of their commodities or services were defined as idle consumers. Landlords belonged to this category. In regarding landlords as idle consumers, Steuart's attitude was ambivalent. While emphasizing that 'the proprietors of lands are by no means included in the class of idle consumers, in every respect' (Steuart 1998 [1767], vol. 4: 204), Steuart could not help acknowledging that:

> they may be considered in this light, with respect to such taxes upon their consumption as they do not draw back from their direct industry, in producing some manufacture which they may sell again, with a profit proportional to the tax they paid.
>
> (Steuart 1998 [1767], vol. 4: 204–5)

Although Steuart did not state this explicitly, the moneyed interest must also be regarded as idle consumers, because they could not freely increase the rate of interest according to the consumption taxes they had to pay. People who could recover consumption taxes were regarded as industrious consumers; these were people who consumed only for the purpose of maintaining their subsistence and business. However, even with respect to the industrious classes, spending on luxuries was regarded as idle consumption.[21] Governments had to be careful concerning '*the different effect of taxes, as they severally affect those who consume in order to reproduce, and those who consume in order to gratify their desires*' (Steuart 1998 [1767], vol. 2: 67; emphasis in original).

On the basis of this system, Steuart demonstrated, in Books 4 and 5 of the *Principles*, how governments could harmoniously develop the economy at the stage of inland trade through public-finance policies. Steuart examined in detail the shifting and incidence of taxes as well as the macroeconomic effects of government expenditure.

2.3 The shifting and incidence of taxation

To Steuart, one of the fundamental principles of taxation was to impose taxes on 'fruits' – not on the 'funds'.[22] The funds were composed of the produce of the earth, the produce of the industry of humans, and humans' personal service. Fruits were defined as the surplus that remains after deducting from the fund expenses necessary to maintain production and service (Steuart 1998 [1767], vol. 4: 138–41).

Steuart identified three categories of taxes: proportional taxes, cumulative taxes, and personal taxes. Excises, customs, and stamp duties were called proportional taxes 'because a man is never subjected to them, but in proportion to his expence; and his expence ought naturally to proceed from his income' (Steuart 1998 [1767], vol. 4: 241). These might be called 'indirect taxes' in present-day terminology. Land taxes, poll taxes, and assessed taxes were called cumulative taxes 'because the reason given for imposing them, is, that it is just every one should pay a general tax, for the support of the state, in proportion to his abilities' (Steuart 1998 [1767], vol. 4: 193–4): they might today be called 'direct taxes'. Personal taxes were exemplified by personal services in public works and the military.

2.3.1 Proportional taxes

Steuart showed a difference in the shifting and incidence between proportional and cumulative taxes. A proportional tax is 'consolidated as it were with the price of the commodity, and must of necessity raise the price of it' (Steuart 1998 [1767], vol. 4: 155). Hence, the burden of the tax would be carried by consumers, not by the producers of the commodity. If the commodity taxed was a luxury good, the consumers could not shift the burden onto others. If the taxed commodity was a production good, producers who used the commodity taxed would raise the price of the commodity they produced: consequently, the proportional tax would ultimately fall on the people who consumed the final product.

If a tax was imposed on a necessary good of life, it would raise the price. Idle consumers would have to carry the burden of the tax by spending more money on necessities. The industrial classes might work harder to make up for the rise in the price of the commodity. In this case, the price of work would not rise: however, this could not always happen. Although Steuart did not think that the price of work was directly determined by the price of necessities, he acknowledged that 'the price of the market [for work] may in a great measure be influenced by the price of subsistence' (Steuart 1998 [1767], vol. 4: 163). In fact, '[w]hen the expence of living is insensibly and universally augmented, by the effect of proportional taxes, then the industrious man, who enjoys neither superfluity or idleness, may and can augment the price of his work in proportion' (Steuart 1998 [1767], vol. 4: 175–6).[23] Thus, a proportional tax on the necessities of life would increase the price of work, and the industrious classes – particularly the lower classes – could recover the proportional taxes. Steuart concluded that '[t]he best method of raising money upon the lower classes of the industrious, is rightly to lay their consumption under proportional taxes, which they may easily draw back; because they will raise the price of their work proportionally' (Steuart 1998 [1767], vol. 4: 245).

Although Steuart did not clearly demonstrate it, an increase in the price of work would raise the money price of all commodities. The people who ultimately carried the burden of proportional taxes were idle consumers; typically, the landlords and the moneyed interest:

> How absurd, therefore, is it either to say, that all taxes fall ultimately upon land; or as others, for no better reason, pretend, that they fall upon trade. I say, that this class of taxes which I have now been describing, and which I shall still more fully explain in a subsequent chapter, never can fall either upon, or affect any person but the idle; that is to say, the not industrious consumer.
>
> (Steuart 1998 [1767], vol. 4: 148)

The idle consumers had to pay the increase in the price of the commodity taxed as well as the increase in the price of all commodities caused by the rise in the price of work of the industrious classes.

2.3.2 Cumulative taxes

Steuart assumed that, in contrast to proportional taxes, cumulative taxes would 'affect the possessions, income, and profits of every individual, without putting it in their power to draw them back in any way whatever; consequently, such taxes tend very little towards enhancing the price of commodities' (Steuart 1998 [1767], vol. 4: 150). Because people could not shift the burden of cumulative taxes onto others, lower-class people would be harmed most severely by such taxes. Hence, 'cumulative taxes never should be raised upon such classes of inhabitants as have no income but their personal industry, which is so frequently precarious' (Steuart 1998 [1767], vol. 4: 153).

A land tax was the least objectionable tax in the category of cumulative taxes: landlords usually had enough income and property to pay such a tax. To Steuart, the French tithe which the Marechal de Vauban proposed – a tithe imposed in proportion to the total product of land – was the worst tax of all taxes on land. Such a tithe would place an excessive burden on landlords and tenants in the land of poor quality (Steuart 1998 [1767], vol. 4: 222). By contrast, the English land tax in Steuart's period was imposed on the fixed value of land at the rate of between one shilling and four shillings per pound. Landlords in practice paid a fixed amount of land tax irrespective of any increase in the productivity of their land. Consequently, the fixed land tax escaped from discouraging the improvement of land, although it was an unequal tax because 'the same land may be worth more one year than another' (Steuart 1998 [1767], vol. 4: 232). In order for the land tax to be equal, the value of land had to be re-estimated every year subject to the value of the rent actually paid. However, Steuart thought that such a variable land tax would discourage the improvement of land. From this viewpoint, Steuart proposed to fix the then current valuation of land for at least a hundred years: 'This is no more than giving every one a lease as it were of his land-tax for a hundred years' (Steuart 1998 [1767], vol. 4: 233). Although Steuart acknowledged a land tax as the least objectionable cumulative tax, he attempted to keep it as light as possible.

If a land tax was unobjectionable because it was paid by idle consumers, so was a tax levied on the interest from money. However, Steuart did not think it possible to obtain revenue through a tax on interest. In contrast to landlords, moneyed men could escape from a direct tax by collecting debts and sending money away to foreign countries. An outflow of money from the common domestic market would strike a fatal blow to the development of the economy. If the collection of debts and the export of money were prohibited, the credit system would be destroyed for the future, and no more money would be lent. This result would have 'the effect of hurting the credit of landed men, who have frequently no good security but their land to give' (Steuart 1998 [1767], vol. 4: 194). Thus, Steuart concluded that 'all attempts to lay a tax upon the income of so fluctuating a property as money, where capital is demandable, will prove unsuccessful' (Steuart 1998 [1767], vol. 4: 194).

Cumulative taxes should not be imposed on the profits of the industrious classes. Steuart regarded profits fundamentally as capital. With respect to the profits of trade, Steuart stated:

> I rather consider them as stock, which, according to principles, ought not to be taxed. My reason for not considering them as income, is because we have supposed them to be accumulated by the merchant into his trading stock. . . . If they be spent by the merchants, then they are undoubtedly income, and will be affected by proportional taxes; but as they may also not be spent, and become stock, the cumulative tax will affect them in both cases.
>
> (Steuart 1998 [1767], vol. 4: 196)

The profits of farmers and manufacturers could also be regarded as capital, which should not be taxed directly. Cumulative taxes imposed on the profits of professionals – such as lawyers, attorneys and physicians – were not advisable, although their profits could not always be thought of as capital. Such an income tax would cause abuse in the collection and inequality in the imposition of the tax. Steuart thought that the idea of a general income tax was merely imaginary, 'because in the execution it will be found, that no body will really pay what they ought, except those whose income cannot be concealed' (Steuart 1998 [1767], vol. 4: 227). Steuart discerned the fatal defect of an income tax – namely tax evasion by professionals – although he had never seen such a tax introduced.

Cumulative taxes, therefore, would distress the lower classes; impede the improvement of land; foster exports of money to foreign countries; reduce the capital of the industrious classes; and induce professionals to hide their incomes. Consequently, cumulative taxes would check the growth of national wealth. A tax on the profits of the industrious classes and a tax on wages could be 'consolidated' by including them in the price of commodities, (1) if taxes were proportional to the subject taxed; (2) if this proportion was clearly evident; and (3) if taxes were levied frequently and regularly (Steuart 1998 [1767], vol. 4: 150–1, 174, and 195). In this case, cumulative taxes would resemble proportional taxes. However, this might not always be the case. Consequently, Steuart in general recommended proportional taxes over cumulative taxes (Steuart 1998 [1767], vol. 4: 182).

Steuart accepted the coming liberal and commercial society as an inevitable stage of social development.[24] However, Steuart thought that 'upon such a revolution of national circumstances, a popular government may very probably take place, if the statesman do not take proper care to prevent it' (Steuart 1998 [1767], vol. 2: 32). Taxation could be an effective way for the government to keep its sovereignty:

> From these principles (which I have been obliged to anticipate) we may gather the necessity of taxes, in states where foreign trade begins to decay. Without them, there is no security for government against the power of domestic wealth. . . . The statesman, therefore, must hold the reins; and not commit the management of the horses to the discretion of those whom he is employed to conduct.
>
> (Steuart 1998 [1767], vol. 2: 34)

Steuart thought that proportional taxes would form the basis of the taxation system under a limited monarchy, whereas cumulative taxes would form the basis of the system under an absolute monarchy. Because absolute monarchs tended to be jealous of growing wealth, they would impose cumulative taxes on those people who were growing richer. In contrast, limited monarchs should resort to proportional taxes, because they had less power to prevent people from growing richer. Limited monarchs should leave untouched profits which would make up a stock for the industrious classes – the main driving force of economic development. Meanwhile, limited monarchs could draw their revenue from 'those who from rich are growing poorer' (Steuart 1998 [1767], vol. 2: 33) – namely, idle consumers.

Thus, Steuart generally preferred proportional taxes, considering them more suitable to the spirit of the people at the stage of a liberal and commercial society, as well as to the spirit of the statesman who had to keep the power to control such a new society.[25] In other words, wealth and power could balance each other through the mechanism of proportional taxes:

> This augmentation of wealth produces a double advantage to the statesman: for, besides the increase of the public revenue, the progress of luxury changing the balance of wealth constantly, by removing it from the rich and extravagant, to the poor and laborious, renders those who were formerly rich, and consequently powerful, dependent upon him for their support. By the acquisition of such persons, he gains additional credit, and supports his authority. Thus wealth and power circulate and go hand in hand.
>
> (Steuart 1998 [1767], vol. 2: 34)

Why could a statesman increase national wealth, as well as the public revenue, by levying proportional taxes? Why would not this be the case with respect to cumulative taxes? Would there be any problem if government expenditure was financed by public debt instead of taxes? In order to answer these problems, Steuart considered the macroeconomic effects of taxation and public debt.

2.4 The macroeconomic effects of taxation and public debt

2.4.1 Taxation

On the basis of the principle that governments 'must consider the advancement of common good as a direct object of private interest to every individual' (Steuart 1998 [1767], vol. 1: 285), Steuart authorized governments to impose taxes on the people. With respect to taxation, the people were classified as follows:

> First, Those who receive the amount of taxes, viz. the creditors and servants of the state, and those to whom the state gives employment. Secondly, Those who advance the taxes, viz. all the different classes of the industrious manufacturers of excisable goods.[26] Thirdly, Those who pay taxes, viz. all the rich and idle; or, in other words, all those who cannot draw back what they have paid.
>
> (Steuart 1998 [1767], vol. 4: 197)

Public money obtained through taxes had to be spent not only on the salaries of public servants and the interest due to public creditors, but also on purchasing manufactures (Steuart 1998 [1767], vol. 1: 293–4). It could also be used to relieve manufacturers should the price of their work fall below the level of subsistence. An increase in demand for manufacturers' work would increase demand for agricultural products and commercial services. Demand for land would also increase and improvement of land would be promoted. Consequently, the income produced from the rent of land would rise. The expansion of markets for manufactures, agricultural products and commercial services would require an increase in the means of exchange – that is, money: 'so a statesman when he intends *suddenly* to augment the taxes of his people, without interrupting their industry, which then becomes still more necessary than ever, should augment the circulating equivalent in proportion to the additional demand for it' (Steuart 1998 [1767], vol. 4: 23–4; emphasis in original). For this purpose, the government had to establish the banking system which issued paper money on the basis of mortgages, because, as has been argued in Section 2.2 of this chapter (page 19), paper money would balance the supply of money with demand for it, preventing the rate of interest from rising.

If the supply of money was sufficient, the common domestic market would expand because of government expenditure financed by taxation. Thus, taxation had a demand-creating effect, which would advance national prosperity. However, such a result held true only with respect to proportional taxes. Steuart assumed – without giving any persuasive explanation – that cumulative taxes would reduce the consumption of those who would pay the taxes:

> I cannot discover the shadow of a reason, to conclude that taking arbitrarily away from some individuals, a part of their gains by cumulative taxes ... must in any respect imply an incitement in the consumers to demand more; and without this it never can excite the industrious man to augment the supply.
>
> (Steuart 1998 [1767], vol. 4: 211)

As has been shown in the previous section, cumulative taxes were assumed to fall on every class of society, but were particularly distressing for the industrious classes who could not afford to maintain their consumption level. In contrast, proportional taxes would fall on idle consumers alone, who could afford to maintain their consumption level after paying taxes.

Even if all taxes were proportional and consequently fell on idle consumers alone, such taxes might only transfer consumption from idle consumers to the government: no new demand would be created in this case. 'The answer is, that it might be so, or not' (Steuart 1998 [1767], vol. 4: 212). If idle consumers paid taxes by reducing their consumption of domestic commodities, it was only a transfer of consumption. If idle consumers paid taxes from their hoarded money, it would create a demand for commodities. Thus, proportional taxes, at least in some circumstances, might draw money into circulation that would have otherwise remained in the pocket of idle consumers.

Proportional taxes could not only absorb money hoarded, but could also transform solid property into money through the banking system. If idle consumers did not have enough money to maintain their consumption after the payment of taxes, they would sell their property to money holders or borrow money from banks by mortgaging property. In this case, taxes would create demand and encourage industry. It was logically possible to increase proportional taxes to the point where idle consumers would have transformed all of their solid property into money:

> If we suppose the rich to set out on a plan of living upon their capitals, instead of living upon their incomes ... then indeed taxes may augment to a degree not to be estimated. ... [I]n proportion to credit and industry, it might be possible ... to produce commodities to the value of the whole property of the most extended kingdom. ... Proportional taxes, though carried to their utmost extent, will not deprive an industrious man of his physical-necessary, nor of the reward of his ingenuity.
>
> (Steuart 1998 [1767], vol. 4: 190–1)

By transforming solid property into money, as well as by absorbing redundant money, 'taxes promote industry ... in consequence of their being expended by the state; that is, by increasing demand and circulation'

(Steuart 1998 [1767], vol. 4: 211). On the basis of this proposition, Steuart was opposed to a reduction in or abolition of taxes. In particular, tax reduction should be avoided immediately after the end of a war. At such a time, taxes should be increased rather than reduced:

> We have said above, and experience proves the truth of it, that at the end of a war circulation becomes too full for domestic uses; and that the superfluity of money is realized upon property. This is the consequence of a sudden stop in national expence. Were taxes at such a time augmented, part of this regorging money would find a vent by the augmentation upon domestic circulation which taxes would occasion.
>
> (Steuart 1998 [1767], vol. 4: 130)[27]

Steuart's view of the macroeconomic effect of taxation can be summarized as follows: if taxes were proportional taxes alone, and if a banking system was established, taxes, falling only on idle consumers, would create an effectual demand for the work of the industrious classes. Such taxes could increase to the point where all of solid property possessed by idle consumers would be transformed into money. As long as Steuart's asymmetrical assumptions between proportional and cumulative taxes were accepted, his demand-creating theory of taxation was consistent with his theory of tax incidence. Although the landlords and the moneyed interest – idle consumers – paid the proportional taxes, they would be compensated for their payment, because the income produced from the rent of land would rise and demand for money would increase. Consequently, taxation would enrich the whole nation. If this were true, by whom were proportional taxes supported? Steuart answered this question clearly:

> Whence then do taxes proceed? From what fund do they arise? What interest do they affect? I can solve all these difficulties. . . . It arises from the price paid for time well employed; which produces nothing when spent in idleness. This is the fund out of which the greatest part of taxes is paid; it is a fund created by the industrious Britons, which I hope will increase for many centuries, though taxes should increase in proportion.
>
> (Steuart 1998 [1767], vol. 4: 209–10)

An increase in the revenue of every class resulting from an expansion of the market was brought about only through the additional work of the industrious classes. In Steuart's view, therefore, the true supporter of proportional taxes – as well as the true driving force of national prosperity – was the industrious class of the country.

2.4.2 Public debt

In the *Principles*, credit and debt were discussed (in Book 4) prior to taxation (in Book 5). Steuart was clearly aware of the causal relationship between credit, debt, and taxation:

> We see also how credit has engaged nations to avail themselves of it in their wars, and how, by the use of it, they have been led to contract debts; which they never can satisfy and pay, without imposing taxes. The doctrine, then, of debts and taxes will very naturally follow that of credit in this great chain of political consequences.
>
> (Steuart 1998 [1767], vol. 1: 34–5)

Steuart divided credit into three categories: 'private credit', 'mercantile credit', and 'public credit'. Private credit was most solid of all, because it was 'established upon a security, real or personal, of value sufficient to make good the obligation of repayment both of capital and interest' (Steuart 1998 [1767], vol. 3: 160). In contrast, mercantile credit was the most precarious: it was 'established upon the confidence the lender has, that the borrower, from his integrity and knowledge in trade, may be able to replace the capital advanced, and the interest due during the advance, in terms of the agreement' (Steuart 1998 [1767], vol. 3: 160). Finally, public credit was:

> established upon the confidence reposed in a state, or body politic, who borrow money upon condition that the capital shall not be demandable; but that a certain proportional part of the sum shall be annually paid, either in lieu of interest, or in extinction of part of the capital; for the security of which, a permanent annual fund is appropriated, with a liberty, however, to the state to free itself at pleasure, upon repaying the whole; when nothing to the contrary is stipulated.
>
> (Steuart 1998 [1767], vol. 3: 160)

The solidity of public credit was higher than that of mercantile credit, and lower than that of private credit.

Although Steuart classified these three types of credit according to the object of confidence and the nature of the security – rather than the condition of the borrower – long-term public debt represented public credit. Historically, private credit had been the basis of public credit (Steuart 1998 [1767], vol. 3: 161).[28] Because the solidity of public credit would influence mercantile credit, the death of public credit – the state bankruptcy – would destroy general credit and commerce.

Steuart did not support Hume's scheme of voluntary default. Such a policy would impoverish the stockholders, and reduce their consumption. Taxes which had been imposed in order to pay the interest on the public debt would be repaid to taxpayers, and their consumption would probably increase. However, because a portion of the repaid taxes would return to the banks and be 'realized' in the form of solid property, the increase in taxpayers' consumption would not compensate for the diminution in stockholders' consumption. Consequently, state bankruptcy would cause a national recession, as well as a crisis of general credit. Believing that 'a total bankruptcy, and abolition of taxes, would bring this nation back to the situation it was in before taxes and debts were known' (Steuart 1998 [1767], vol. 4: 113), Steuart concluded that 'the best resolution a nation can take, is to adhere to [public credit] to the last extremity, and to banish from their thoughts every idea which may be repugnant to it' (Steuart 1998 [1767], vol. 4: 117).

How far could public credit be extended? Steuart considered this problem the most important in political economy (Steuart 1998 [1767], vol. 4: 116). Steuart handled it by dividing the public debts into foreign and domestic debts. The interest payments on foreign debts would export specie necessary to the domestic circulation. A bankruptcy would happen if the balance of trade amounted to less than the interest payments. However, it was not advisable to break faith with foreigners. It would be impossible 'that a country might execute so glaring a scheme of treachery to all her neighbours, and still continue her correspondence with them in the open way of trade' (Steuart 1998 [1767], vol. 4: 117). Steuart claimed that 'the most important object in paying off debts, is to get quit of those due to strangers' and that 'whatever circumstance has a tendency towards diminishing the burden of foreign debts, should be encouraged' (Steuart 1998 [1767], vol. 4: 116–17).

Compared with foreign debts, domestic debts were less harmful. Like a tax, a domestic debt 'has the good effect of giving vent to the stagnation, and throwing the money into a new channel of circulation' (Steuart 1998 [1767], vol. 4: 104). Money obtained through public debt would be used to increase demand for the work of the industrious classes. Steuart did not believe that an increase in domestic debts would necessarily produce national bankruptcy. However, practically, this could be the case:

> Were the trade and industry of England to decay, the amount of all the permanent taxes might so far diminish, as to prove insufficient to pay the interest of the national debt, and defray the expence of civil government. Were the people to be blown up into a spirit of revolt against taxes, the same event would probably happen. In either case, the natural and immediate consequences of the bankruptcy would probably follow.
>
> (Steuart 1998 [1767], vol. 4: 109–10)

Domestic public debt should be maintained below the level at which the total amount of taxes (minus necessary expenses of civil government) was equal to the total interest payments on the public debt.[29] However, there was another important factor to consider: the interest payments on the public debt would transfer money from the taxpayers to the public creditors, and consequently change the distribution of income. Steuart realized this:

> When a statesman, therefore, establishes a system of public credit, the first object which should fix his attention is to calculate how far the constitution of the state, and its internal circumstances, render it expedient to throw the revenue of it into the hands of a moneyed interest. I say, this is the most important object of his deliberation; because the solidity of his credit depends upon it.
>
> (Steuart 1998 [1767], vol. 4: 7)

If a large amount of money were transferred to the public creditors, taxpayers would complain of heavy taxes: this would make the constitution unstable. Moreover, if they were 'blown up into a spirit of revolt against taxes' (Steuart 1998 [1767], vol. 4: 109), the government would go bankrupt, and public credit would collapse. Would there be any way to neutralize – or weaken – the distributive effect of the interest payments? Although Steuart did not spell out the answer to this question, his theory of tax incidence reveals it.

Let the moneyed interest be creditors, and landlords the sole taxpayers.[30] If government borrowing increased, in the long run land would be confiscated by the moneyed interest. This is because landlords would have to sell their land to the moneyed interest in order to pay taxes to the government. The moneyed interest – who paid money in exchange for land – would recover their money from the government as interest on the public debt: they would hold both money and land. Consequently, the class of landlords would disappear, and a new moneyed-and-landed class would appear. In fact, Steuart recognized that, in Britain, 'interest of the creditors will daily gather strength, both in parliament and without doors' (Steuart 1998 [1767], vol. 4: 95). Hence, 'it is very natural to conclude . . . that at last, the creditors of the nation may become the masters of it' (Steuart 1998 [1767], vol. 4: 95). However, this was not what Steuart wished: 'When any one interest becomes too predominant, the prosperity of the state stands upon a precarious footing. Every interest should be encouraged, protected, and kept within due bounds' (Steuart 1998 [1767], vol. 4: 95).

The security of public credit depended on a balance between creditors and taxpayers, while the smooth expansion of markets required the security of credit. A balance between the moneyed interest and the landlords was a necessary condition for economic development and social stability. If public credit was opened to the landlords as well as the moneyed interest, the landlords could become creditors by buying public debt from the government or the moneyed interest. The landlords would do so, because '[t]he ease and affluence of those, on the other hand, who have their capitals in their pocket-books, is very attracting to the eyes of many landlords' (Steuart 1998 [1767], vol. 4: 98). The balance between the moneyed interest and the landlords would be maintained through a voluntary exchange between land and debt:

> The firm establishment of public credit tends greatly to introduce these reciprocal sentiments of good-will among the two great classes of a people, and thereby to preserve a balance between them. The monied interest wish to promote the prosperity of the landlords; the landlords, the solidity of credit; and the well-being of both depends upon the success of trade and industry.
>
> (Steuart 1998 [1767], vol. 4: 98)

The exchange between land and debt would not 'operate a vibration in the balance of wealth': in other words, it would not directly increase national wealth. However, it would indirectly contribute to the progress of trade and industry by promoting the security of credit.

In order to keep the balance of power between the landlords and the moneyed interest, the government had to choose taxes that would fall equally on the two classes. Proportional taxes were such taxes. They affected the landlords and the moneyed interest equally as idle consumers, whereas they did not fall on the industrious classes. The landlords and the moneyed interest had to pay the taxes according to their consumption – not according to the source of their income. Because both the landlords and the moneyed interest possessed public debt as well as land, and because they were the sole taxpayers, the payment of taxation and the receipt of interest on public debt would cancel each other out: idle consumers would pay taxes in order to receive interest.[31]

Thus, if the landlords and the moneyed interest merged through a voluntary exchange of land and public debt, and if all taxes were proportional taxes, then the interest payments by taxes would not produce a distributive effect. Because proportional taxes could increase to the point where all solid property possessed by idle consumers would be transformed into money, the value of solid property possessed by idle consumers would create general limits to public credit. This could have been Steuart's answer to the question 'how far could public credit be extended' with respect to domestic debts, although Steuart did not explicitly state it.

Finally, let us consider the reason why Steuart proposed to abolish the land tax and establish a general sales tax. Steuart recognized the fact that 'the landlord . . . who pays a land tax, as well as his proportion upon his consumption, is more hardly dealt with than the proprietor of the other branch of solid property, the funds, who pays his proportion only of the last' (Steuart 1998 [1767], vol. 4: 100). A cumulative tax on the income of the moneyed interest would fail to balance the land tax, because moneyed men could escape from such a direct tax by collecting debts and sending money away to foreign countries. The inequality of the land tax violated Steuart's principle of taxation that 'the load of all impositions may be equally distributed upon every class of a people who enjoys superfluity' (Steuart 1998 [1767], vol. 4: 100). A land tax would also discourage the improvement of land, preventing the production of a food surplus necessary to the subsistence of manufacturers. Thus, Steuart proposed to abolish the land tax in order to increase the food surplus as well as to maintain the balance between the landlords and the moneyed interest that together constituted the class of idle consumers. In compensation, Steuart proposed to extend proportional taxes as far as possible, culminating in his recommendation of a general sales tax.

In the Preface of the *Principles*, Steuart claimed that 'I have rejected all party opinions whatever' (Steuart 1998 [1767], vol. 1: 5). Nevertheless, his proposal of a general sales tax was designed to lighten the relative share of the tax burden imposed on the landlords, and increase that on the moneyed interest – 'a class in the state but lately known; the capital of their wealth is hidden; and opinions concerning their rank, and the figure they ought to make, are as yet unformed' (Steuart 1998 [1767], vol. 4: 130). The general sales tax could maintain the balance between the landlords and the moneyed interest. The tax would not fall on the industrious classes: it would increase demand for their work. The common domestic market would expand, and the national product would increase. If the national product continuously increased, prices would begin to fall. Domestic manufactures would regain the ability to compete with foreign manufactures, and foreign markets would be restored (Steuart 1998 [1767], vol. 4: 159–60). Thus, because of the new system of taxation, economy at the stage of inland trade would begin to develop again.[32]

2.5 Conclusion

Steuart believed that government expenditure would create a demand for the work of the industrious classes if public money were spent on purchasing manufactures and relieving poor manufacturers. As a result of this policy, every class of society would be enriched. However, such a result could be produced only if proportional taxes were imposed. In his theory of tax incidence, Steuart demonstrated that proportional taxes would fall on idle consumers – namely the landlords and the moneyed interest – whereas cumulative taxes would be borne by every class of society except the moneyed interest, who could send their capital away to foreign countries. Proportional taxes would absorb idle consumers' money which, without the taxes, would be hoarded: the taxes would also transform their solid property into money. Thus, government expenditure financed by proportional taxes could be increased to the limit set by the hoarded money and the value of solid property possessed by idle consumers.

If all taxes were proportional taxes, and if the landlords and the moneyed interest merged through a voluntary exchange of land and public debt, the interest payments on public debt would not produce a distributive effect: tax payments and interest receipts would cancel each other out. In this case, the same limits would be applied to government expenditure financed by domestic debts as to government expenditure financed by proportional taxes.

Proportional taxes would not only promote economic development without imposing a burden on the industrious classes, but also maintain the balance between the landlords and the moneyed interest, and consequently produce constitutional stability. To Steuart, the fair and efficient system of taxation was a wide-ranging system of proportional taxes. For this reason, Steuart proposed a general sales tax as an answer to Hume's pessimistic view of public credit, national economy, and constitutional stability in the Britain of the future.

Steuart founded the theory of public finance on a systematic account of political economy for the first time. As long as his assumptions are accepted, Steuart's self-appraisal that '[t]he principles deduced from all these topics, appear tolerably consistent' (Steuart 1998 [1767], vol. 1: 7) is defensible with respect to the theory of taxation and public debt.[33] However, his assumption that proportional taxes would always raise the price of the commodity taxed, whereas cumulative taxes would never be shifted on to the price, seems arbitrary. It was also arbitrary to presume that idle consumers would maintain their level of consumption when proportional taxes were imposed on their consumption, whereas they would not do so in the case of cumulative taxes. Moreover, it was questionable whether Steuart's scheme of a general sales tax would work in an open economy. If prices increased because of the tax, and if the growth of production could not offset the increase in prices, the balance of trade would become a deficit. Specie would flow out of domestic circulation, and consequently – without the specie-flow price mechanism which Hume described – industry and trade would decline.[34] Finally, in Steuart's political economy, the incidence of taxes was not considered within the production system which regularly produced profits of capital and rent of land by employing labour. The attempt to establish a more general theory of tax incidence had to be taken up by Adam Smith.[35]

Notes

1 This chapter draws on Dome (2001).
2 Steuart supported the 1745 revolt by the Jacobites, and fled from Britain after the failure of the revolt. The formal pardon was given to him in 1771. For the latest biography of Steuart, see Skinner (1998).
3 '[A]n equal land-tax, and moderate duties upon the whole consumption, would

have produced such a sum; and if this could have been compassed, the landed men had undoubtedly been in a better condition than they are at present, and we had avoided the vast debt, which, notwithstanding the peace, must needs be a weight upon the king's affairs' (Davenant 1967 [1698], vol. 1: 143). See also Davenant (1695: 159).

4 In fact, Steuart often referred to Davenant's works on public debt and taxation. Doujon (1994: 504) indicates that Davenant was the most quoted author in Steuart's *Principles*.

5 See Kennedy (1964 [1913]: 97–112) and Dowell (1965, vol. 2: 95–105).

6 This tradition can be traced back to Sir William Petty. For his preference for the excise to the land tax, see Petty (1997 [1662]: 94–5).

7 The rehabilitation of Steuart is continuing even now: see, for example, Skinner (1993 and 1998); Doujon (1994); Yang (1994); Redman (1996); Urquhart (1996); Brewer (1997); Kobayashi (1998); and Tortajada (1999).

8 Sen (1957, 121) argues that 'the way in which [Steuart] integrated taxation with public borrowing and public expenditure, and especially the important and constructive role that he ascribed to public borrowing, were entirely new'. Seligman (1969 [1927]: 117–18) shows that the 'fullest discussion of the incidence of taxation before Adam Smith is to be found in the works of Sir James Steuart'. Yang (1994: 226–73) integrates Steuart's microeconomic theory of tax incidence and his macroeconomic theory of taxation and public debt. Yang demonstrates that the macroeconomic effects on output, the price level and the rate of interest depend on whether the tax would shift onto the price.

9 Following Hume, Steuart argued that people's demand for non-food commodities stimulated production of surplus food (Steuart 1998 [1767], vol. 1: 49). Eagly (1961) calls this process 'the aspiration effect'.

10 Steuart acknowledged the mutual relationship between commerce and military power. Namely, while arguing that '[t]rade and industry cannot flourish without method and regularity; taxes and standing armies are a systematical execution only of the old plan, for preserving the power, safety, and independence of the nations of Europe' (Steuart 1998 [1767], vol. 2: 120), Steuart acknowledged that 'the military governments now are made to subsist from the consequences and effects of commerce only: that is, from the revenue of the state, proceeding from taxes' (Steuart 1998 [1767], vol. 1: 29).

11 However, Steuart did not insist on a sudden and entire halt to foreign trade. Steuart suggested a phase-out of unfavourable branches. See Steuart (1998 [1767], vol. 2: 15–22).

12 Probably Steuart believed that Britain was reaching the stage of 'inland trade'. For example, Steuart argued: 'England may greatly increase her specie by her trade, and greatly diminish it by her wars: perhaps this may be the fact' (Steuart 1998 [1767], vol. 2: 110).

13 Akhtar (1979: 284) provides a macroeconomic model of a closed economy, arguing that 'Steuart's macroeconomic ideas take *full* shape during the stage of inland trade' (emphasis in original). A model with respect to infant trade is indicated in Akhtar (1978). Yang (1994: 262–73) also developed a Keynesian model in order to examine the macroeconomic effects of taxation and public debt in Steuart's closed system.

14 Brewer (1997: 7) states that, in Steuart's *Principles*, 'the theory of rent is not discussed at all, while farmers' incomes are not divided into wages and profits', and that Steuart, as well as Hume, mainly assumed a system of independent farmers.

15 Steuart defined interest as a reward for 'use of money': 'Money, while it is employed in circulation, can carry no interest; the moment it lies idle to one man, were it but for a day, it may be worth interest to another, who willingly

pays for the use of it, when he has occasion either to buy what he wants, or to pay what he owes' (Steuart 1998 [1767], vol. 4: 248). The rate of interest would be determined by supply of and demand for the use of money (Steuart 1998 [1767], vol. 3: 131–7).

16 Eltis (1986: 68) thinks that, in Steuart, 'Smith's perception that "stock" influences the demand for labour is lacking'; Skinner (1988: 136) indicates that the distinction between rent, profits, and wages, as well as between land, labour, and capital, was less obvious in Steuart's system than Smith's; Doujon (1994: 506) shows that Steuart's system 'lacked a conception of man which gave major impetus to the ideology of economic development'; Brewer (1997: 7) points out that 'neither Hume nor Steuart had a notion of classes based on different types of income, when neither had a developed theory of wages, profits or rent'. By contrast, Perelman (1983: 469) emphasizes that the 'connection between the creation of a wide-spread wage labor relationship and social division of labor was essential to the work of Steuart': nevertheless, Perelman (1983: 482) acknowledges that Steuart 'did not sense the full potential of capital'. I follow the mainstream interpretation with respect to Steuart's incomplete perception of capitalistic production.

17 'Alienation' is what Steuart termed the general exchange of commodities for the purpose of consumption, defining as 'sale' the part of alienation in which commodities were exchanged for money (Steuart 1998 [1767], vol. 4: 183). Steuart thought that taxation, in order to be easy and light, should be confined to sale (Steuart 1998 [1767], vol. 4: 185).

18 Steuart used the term 'effectual demand' when he wrote that '[n]ow because it is the *effectual* demand, as I may call it, which makes the husbandman labour for the sake of the equivalent, and because his demand increases, by the multiplication of those who have an equivalent to give, therefore I say that multiplication is the cause, and agriculture the effect' (Steuart 1998 [1767], vol. 1: 134; emphasis in original). According to Kobayashi (1967: 5), Steuart was the first in the history of economic thought to use the term 'effectual demand'.

19 On the basis of his criticism of the quantity theory of money, Steuart also rejected Hume's view of the specie-flow price mechanism. See Steuart (1998 [1767], vol. 2: 92–104).

20 Doujon (1994: 504–5) emphasizes that Steuart assumed a statesman disciplined by the principles of Machiavellian virtue. However, Steuart regarded such a statesman as neither realistic nor suitable for liberal and commercial society: 'I have sometimes entered so heavily into the spirit of the statesman, as to be apt to forget my station in the society where I live; and when as a private man I have read over the work of the politician, my natural partiality in favour of individuals has led me to condemn, as Machiavellian principles, every sentiment approving the sacrifice of private concerns in favour of a general plan' (Steuart 1998 [1767], vol. 1: 11–12).

21 With respect to the definition of luxury – consumption not indispensable to man's subsistence – Steuart noted: 'As my subject is different from the doctrine of morals, I have no occasion to consider the term *luxury* in any other than a political sense, to wit, as a principle which produces employment, and gives bread to those who supply the demands of the rich. For this reason I have chosen the above definition of it, which conveys no idea, either of abuse, sensuality, or excess' (Steuart 1998 [1767], vol. 1: 50n; emphasis in original). The term 'idle consumers' should also be interpreted as excluding a moral element.

22 Sen (1957: 128) shows that Steuart had the same ideals of taxation as Smith: equality; certainty; convenience; and economy. Sen credits these maxims to Petty.

23 With respect to the salt duty, Steuart clearly stated 'that [the salt tax] being

imposed upon an article of subsistence, it operates immediately on the price of the salt, *and consequently only on the price of labour*' (Steuart 1998 [1767], vol. 4: 228; emphasis added).

24 For the interpretation of Steuart as an anti-liberal scholar, see in Perelman (1983: 474–5), Anderson and Tollison (1984: 464), Eltis (1986: 64–5), and Redman (1996: 56–8). In contrast, the standard view – that Steuart, as well as Hume, prepared the way for Smith's idea of a liberal society based on economic prosperity – is seen, for example, in Skinner (1962: 35–6, 1966: lxxxiii, and 1981: 30), Hutchison (1988: 350–1), and Brewer (1997: 17). This chapter follows the standard view.

25 Steuart's anti-commercial statements are seen, for example in his famous praise of Sparta in Chapter 13, Book 2 of the *Principles*, 'How far the Form of Government of a particular Country may be favourable or unfavourable to a Competition with other Nations, in matters of Commerce', and in Chapter 14, 'Security, Ease and Happiness, no inseparable Concomitants of Trade and Industry'. Of Lycurgus's plan to discourage commercial activities, Steuart wrote: 'The republic of Lycurgus represents the most perfect plan of political oeconomy, in my humble opinion, anywhere to be met with, either in ancient or modern times' (Steuart 1998 [1767], vol. 1: 267). However, Steuart introduced these chapters 'purposely to serve as an illustration of general principles, and as a relaxation to the mind, like a farce between the acts of a serious opera' (Steuart 1998 [1767], vol. 1: 277). Thus, Steuart returned to the main issue in Chapter 15, 'A general View of the Principles to be attended to by a Statesman, who resolves to establish Trade and Industry upon a lasting Footing' (Steuart 1998 [1767], vol. 1: 277).

26 In the first edition, this sentence did not include the words 'manufacturers of excisable goods' (Steuart 1998 [1767], vol. 4: 197n). This revision may indicate that, after publication of the first edition of the *Principles*, Steuart came to regard manufacturers as the most important of the industrious classes.

27 Note that Steuart wrote the taxation chapters of the *Principles* just after the end of the Seven Years War. See also Steuart (1998 [1767], vol. 4: 203).

28 Steuart argued: 'While Princes mortgaged their lands and principalities, in order to obtain a sum of money, they acted upon the principles of private credit. This was the case in the more early times, before government acquired that solidity which is necessary to establish a firm confidence. In proportion as it drew toward a regular system, the dawn of [public] credit put on appearances analogous to the solidity of the fund upon which it was established' (Steuart 1998 [1767], vol. 4: 10–11).

29 Stettner (1945: 462) and Sen (1957: 123) point out that the history of public debt in Britain proves Steuart's optimistic view was closer to the truth than the pessimistic view of such contemporaries as Hume and Smith: at least, the British government was never bankrupted by public debt. However, Williamson (1985: 161–84) empirically demonstrates that the crowding-out effect of public debt slowed down British economic growth before the 1820s.

30 Steuart indicated that, according to experience, 'landed men commonly exceed, and monied men commonly live within their income' (Steuart 1998 [1767], vol. 4: 132). In the following discussion, however, I will ignore the difference in the propensity to consume between the landlords and the moneyed interest.

31 In this case, the means by which government expenditure is financed, be those means a lump-sum tax or a perpetual public debt, would have no influence on macroeconomic distribution. Under either, idle consumers alone would pay government expenditure.

32 Doujon (1994: 511) argues that Steuart's final purpose was to reach the stage of frugal foreign trade.

33 Steuart's *Principles* – like Ricardo's *Principles of Political Economy, and Taxation* – might be characterized by its method of deduction. However, Hutchison (1988: 350–1) states that Steuart's 'wise methodological caution and unpretentiousness also deserve recognition and, still more, his emphasis on the historical dimension, and historical-institutional relativism – an emphasis he shared with Adam Smith'. I do not deny that Steuart's *Principles* contains rich historical-institutional elements. However, the main purpose of the *Principles* was 'not a collection of institutions' (Steuart 1998 [1767], vol. 1: 7) but to construct a system of deduced principles to be tested by historical-institutional facts.

34 Steuart recognized this problem: 'If [a statesman] wants to reduce prices still lower, in favour of exportation, but find that he has occasion for the amount of certain taxes, which enhance the value of this physical-necessary . . . then let him grant a bounty upon the quantity exported, more than equivalent to compensate the rise of prices occasioned by the taxes paid by those who provide it; and let the people at home continue to pay dearer than strangers, in favour of the state' (Steuart 1998 [1767], vol. 4: 160).

35 Skinner (1981: 22) indicates that 'Steuart's desire to produce a conceptual system whose parts are linked by common principles shows a certain similarity, as to motive, with that later articulated by Adam Smith'. This interpretation holds true with respect to their theories of tax incidence.

3 Adam Smith

3.1 Introduction

At the beginning of Book 4 of *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776; henceforth *Wealth of Nations*), Adam Smith defined political economy as follows:

> Political œconomy, considered as a branch of the science of a statesman or legislator, proposes two distinct objects; first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the publick services. It proposes to enrich both the people and the sovereign.
>
> (Smith 1976 [1776]: 428)

Thus, Smith regarded financing the revenue of the public services – through taxation and public debt – as one of the two main objects in political economy. To Smith, Book 5 of the *Wealth of Nations*, 'Of the Revenue of the Sovereign or Commonwealth', was not simply a supplement to Books 1 to 4, in which the main issue was revenue for the people. Rather, it formed an important subject in its own right.

Smith's theory of taxation and public debt has been examined less thoroughly than his theory of market economy. Moreover, his theory of taxation has been sometimes regarded as 'superficial' (Sraffa 1951–73, vol. 7: 106),[1] 'incomplete' (Peacock 1975: 565), based on 'undependable economic reasoning' (Shoup 1960: 14), demonstrating 'the somewhat disorderly flow of ideas and examples' (Lynn 1984 [1976]: 442), and reflecting 'inconsistencies inherent in various parts of Smith's distribution theory' (Musgrave 1976: 309).

This chapter will demonstrate that Smith, who inherited Hume's legacy, had consistent views on the management of government expenditure, the conditions of a fair and efficient system of taxation, and procedures for debt management. In the following section, Smith's statements concerning public finance in *Lectures on Jurisprudence* will be presented as a preliminary to his full-scale arguments in the *Wealth of Nations*, which will be examined in the third section. The third section is divided into three subsections on government expenditure, taxation, and public debt. The conclusion will show that these topics on public finance were behind Smith's opinions on voluntary separation of the American colonies.

3.2 *Lectures on Jurisprudence*

Before publishing the *Wealth of Nations*, Smith had discussed the subject of taxation and public debt in *Lectures on Jurisprudence*.[2] In the 1762–3 lectures, Smith put forward five objects which the theory of opulence (in other words, political economy) had to consider: the rule of exchange; money; the causes of the slow progress of opulence; taxes or public revenue; and effects of commerce on the manners of the people (Smith, 1978 [1762–3 and 1766]: 353). Taxes and public debt were important, because ill-contrived laws relating to them would be a great disturbance to opulence.

In the 1766 lectures, public revenue, as well as justice, police, and arms, was included in the four great objects of jurisprudence, namely, the theory of law and government (Smith 1978 [1762–3 and 1766]: 398). To Smith, the subject of public finance was a combination of political economy and jurisprudence.

From the viewpoint of jurisprudence, public revenue was indispensable in a civilized country, because it provided the government with an economic foundation for implementing justice, police, and arms. The lecture notes read as follows:

> We may observe that the government in a civilized country is much more expensive than in a barbarous one; and when we say that one government is more expensive than another, it is the same as if we said that the one country is farther advanced in improvement than another. To say that the government is expensive and the people not oppressed is to say that the people are rich. There are many expences necessary in a civilized country for which there is no occasion in one that is barbarous.
>
> (Smith 1978 [1762–3 and 1766]: 530–1)

Thus, Smith was not an unconditional opponent of government expenditure. Moreover, Smith acknowledged that public debt had contributed to constitutional stability in Britain:

> The surplus of mortgages goes into what is called the sinking fund for paying the public debt, which secures the government in the present family, because if a revolution were to happen the public creditors, who are men of interest, would lose both principal and interest. Thus

> the nation is quite secure in the management of the public revenue, and in this manner a rational system of liberty has been introduced into Britain.
>
> (Smith 1978 [1762–3 and 1766]: 421)[3]

National bankruptcy would not only be a breach of faith with the public creditors, but would also destroy constitutional stability. A faithful payment of interest – as well as a regular redemption of the capital by the sinking fund – was a necessary condition of liberty.

However, from the viewpoint of political economy, government expenditure could be 'in reality one of the causes that the progress of opulence has been so slow' (Smith 1978 [1762–3 and 1766]: 529). Smith did not accept Steuart's argument that government expenditure would create an effectual demand and promote economic growth. To Smith, government expenditure financed by taxes and public debt was at best a transfer of resources from the private sector to the public sector. Practically, in many cases, government expenditure would waste resources which could otherwise be used for productive purposes.[4] Moreover, interest payments on public debt transferred money from the industrious classes to idle people:

> an apology is made for the public debt. Say they, tho' we [owe] at present 100 millions, we owe it to ourselves, or at least very little of it to foreigners. It is just the right hand owing the left, and on the whole can be little or no disadvantage. But [it] is to be considered that the interest of this 100 millions is paid by industrious people, and given to support idle people who are employed in gathering it. Thus industry is taxed to support idleness. If the debt had not been contracted, by prudence and œconomy the nation would have been much richer than at present.
>
> (Smith 1978 [1762–3 and 1766]: 514)

In contrast to public debt, taxation did not produce a transfer of revenue from taxpayers to stockholders. However, it could impede economic growth more or less depending on the kinds of taxes. Smith thought it necessary to investigate which taxes might result in 'the least loss or hindrance to the industry of the people' (Smith 1978 [1762–3 and 1766]: 6).

With these considerations in mind, Smith compared taxes on property and taxes on consumption. In *Lectures on Jurisprudence*, Smith already held the four maxims of taxation formally set out in the *Wealth of Nations*: equality, certainty, convenience, and economy. Taxes on property were equal in that they would be proportional to the taxpayer's ability to pay: this meant that taxes on property would not be passed on to other people. A tax on land was advantageous in that it could be imposed without any great cost, and in that the amount would be certain because the value of land (or rent) was known. Moreover, a tax on land would not raise the price of commodities. However, a tax on land could discourage the improvement of land if it was imposed in proportion to rent or produce: the French land tax and English tithes had this disadvantage, whereas the English land tax – which was imposed on the fixed value of rent – escaped it. To tax land alone while leaving money and stock untaxed was apparently unjust. However, it would be a breach of liberty to inspect people's stock and money for purposes of taxation.

Taxes on consumption were unequal, because they were proportional to people's liberality, not their ability to pay: 'Taxes upon pos[s]essions are natural[l]y equal, but those upon consumptions natural[l]y unequal, as they are sometimes paid by the merchant, sometimes by the consumer, and sometimes by the importer, who must be repaid it by the consumer' (Smith 1978 [1762–3 and 1766]: 532). Customs and excise duties were costly to collect: they would also raise the price of commodities. Taxes on the importation of specific commodities may encourage the manufacturing of them: 'In general, however, all taxes upon importation are hurtful in this respect, that they divert the industry of the country to an unnatural channel'; and 'the effects of taxes upon exportation are still more pernicious' (Smith 1978 [1762–3 and 1766]: 535).

Nevertheless, taxes on consumption had the advantage that they would constitute the least infringement on liberty, because they were rarely felt by people who paid them. This advantage satisfied Smith's criteria that '[i]n general whatever revenue can be raised most insensibly from the people ought to be preferr'd' (Smith 1978 [1762–3 and 1766]: 98). In fact, Smith stated that '[t]axes upon consumptions are therefore more eligible than taxes upon possessions, as they have not so great a tendency to ruin the circumstances of individuals' (Smith 1978 [1762–3 and 1766]: 533).

Thus, Smith produced a well-balanced argument with respect to the advantages and disadvantages of taxes on property and consumption, reaching the conclusion that 'taxes both on consumptions and possessions are more or less advantageous to industry according to the manner in which they are levied' (Smith 1978 [1762–3 and 1766]: 533). Smith was generally satisfied with the English system of taxation, composed mainly of taxes on consumption and a land tax: 'the English are the best financ[i]ers in Europe, and their taxes are levied with more propriety than those of any country whatever' (Smith 1978 [1762–3 and 1766]: 534).

In contrast to Hume and Steuart, Smith did not blame the British tax system for its inter-sectoral inequality: whereas the moneyed interest paid consumption taxes alone, landlords had to pay them as well as the land tax. Smith argued:

> The landlord who pays his annual land tax pays also a great part of the taxes on consumptions. On this account the landed interest complains first of a war, thinking the burden of it falls upon them. While on the other hand the moneyed men are gainers, and therefore oppose them.

> This perhaps occasions the continuance of what is called the Tory interest.
>
> (Smith 1978 [1762–3 and 1766]: 532)

In *Lectures on Jurisprudence* Smith maintained a neutral position with respect to: (1) the necessity and the disadvantage of government expenditure; (2) the political advantages and the economic disadvantages of public debt; (3) the merits and faults of consumption taxes and the land tax; and (4) the confrontation between the landed interest and the moneyed interest in relation to the tax system. In keeping with this neutral position, Smith did not propose any specific reform of taxation. It was not until the *Wealth of Nations* that Smith positively proposed to reform the British system of public finance. It was also in the *Wealth of Nations* that Smith put forward a full theory of tax incidence consistent with his political economy.

3.3 The *Wealth of Nations*

In Chapter 3, Book 2, of the *Wealth of Nations*, Smith defined 'productive labour' as 'labour which adds to the value of the subject upon which it is bestowed', and 'unproductive labour' as labour 'which has no such effect' (Smith 1976 [1776]: 330). While productive labourers produced an annual surplus, as well as restoring wages advanced to them, unproductive labourers were supported by the annual surplus which they produced. Unproductive labourers never restored the wages advanced to them. In order to increase national wealth, productive labour as a proportion to unproductive labour had to increase, and the division of labour promoted. Smith considered labour supported by public revenue unproductive:

> The whole, or almost the whole publick revenue, is in most countries employed in maintaining unproductive hands. Such are the people who compose a numerous and splendid court, a great ecclesiastical establishment, great fleets and armies, who in time of peace produce nothing, and in time of war acquire nothing which can compensate the expence of maintaining them, even while the war lasts. Such people, as they themselves produce nothing, are all maintained by the produce of other men's labour.
>
> (Smith 1976 [1776]: 342)

In Book 5, Smith acknowledged three duties of government that were necessary to the 'system of natural liberty': defence; administration of justice; public works and public institutions (Smith 1976 [1776]: 687–8). As the *Lecture on Jurisprudence*, Smith argued that the expense of performing these duties would necessarily increase in a civilized country. In fact, in Britain government expenditure had increased since the Restoration. A portion of expenditure – typically on war – had not only been wasteful but also destructive of national wealth. Nevertheless, national capital had been steadily accumulated by private frugality and individuals' effort to improve their own condition:

> It is this effort, protected by law and allowed by liberty to exert itself in the manner that is most advantageous, which has maintained the progress of England towards opulence and improvement in almost all former times, and which, it is to be hoped, will do so in all future times. ... Let [the governments] look well after their own expence, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will.
>
> (Smith 1976 [1776]: 345–6)

Thus, government expenditure should be limited at least at a level where private frugality and effort could cover the loss of national wealth. Considering this condition, Smith carefully examined the expense of the three duties of government, as well as ways of financing them, namely taxation and public debt.[5]

3.3.1 Government expenditure

In Chapter 1 of Book 5, Smith examined the question of whether every public service had to be covered by the general revenue or paid by the particular beneficiaries.

The first duty of government was defence, which Smith considered 'of much more importance than opulence' (Smith 1976 [1776]: 465). Acknowledging the superiority in efficiency of a well-regulated standing army over a militia – particularly after the invention of firearms – Smith argued that '[i]t is only by means of a standing army ... that the civilization of any country can be perpetuated, or even preserved for any considerable time' (Smith 1976 [1776]: 706). Smith dismissed the republican argument that a standing army was dangerous to liberty. If the sovereign was the supreme commander of a powerful standing army, because of his consciousness of superiority, the sovereign would be more tolerant towards popular complaints and remonstrances than without it. Hence, a standing army was consistent with liberty.[6] However, in contrast to a militia, a standing army had to be supported by public revenue. 'The first duty of the sovereign, therefore, that of defending the society from the violence and injustice of other independent societies, grows gradually more and more expensive as the society advances in civilization' (Smith 1976 [1776]: 707). Because expenditure on defence would benefit the whole of society, it had to be defrayed by general revenue.

The second duty of the sovereign – 'that of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice' (Smith 1976 [1776]: 708–9) – could also be paid by the general revenue, because the whole of society enjoyed the benefit of protection. However, Smith thought that, in order to make the judicial independent of the administrative power, expenses of justice should be covered by the fees of the courts: 'The regular payment of [the judge's] salary should not depend upon the good will, or even the good œconomy of that power' (Smith 1976 [1776]: 723). Thus, Smith removed expenses of justice from the list of public services which the general revenue had to support.

The third duty of the sovereign was to supply what we call now 'public goods', namely:

> erecting and maintaining those publick institutions and those publick works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain.
>
> (Smith 1976 [1776]: 723)

Smith identified three classes of public works and public institutions – those for facilitating: (1) the commerce of the society; (2) the education of youth; and (3) the instruction of people of all ages. Public works and institutions for facilitating commerce were divided into those for commerce in general, and those for particular branches of commerce.[7]

Construction of roads, bridges, canals, and harbours, as well as the coinage and the post, belonged to public works and public institutions for facilitating commerce in general. Smith did not think that these kinds of public services had to be paid for by the general revenue: 'The greater part of such publick works may easily be so managed as to afford a particular revenue sufficient for defraying their own expense, without bringing any burden upon the general revenue of the society' (Smith 1976 [1776]: 724). For example, Smith proposed to charge tolls for using highways, bridges, and canals. A toll could be imposed in proportion to the weight of the carriages: carriers paid the toll in proportion to the wear and tear on the public goods which they used. Because the carrier would shift the toll on to the price of the commodity, it would finally fall on the consumers of the commodity. The consumers would gain more than they lost by the payment of the toll, because they would obtain the commodity at a cheaper price than without such public services. For such a toll, Smith argued that '[i]t seems impossible to imagine a more equitable method of raising a tax' (Smith 1976 [1776]: 725).[8]

Public works and public institutions for facilitating particular branches of commerce – for example, forts to defend specific goods from the natives in an uncivilized country – had to be paid for by a special tax imposed on that branch. Smith took it for granted that a special tax to protect a specific branch of trade had to be administrated by the government. However, in fact:

> in the greater part of the commercial states of Europe, particular companies of merchants have had the address to persuade the legislature to entrust to them the performance of this part of the duty of the sovereign, together with all the powers which are necessarily connected with it.
>
> (Smith 1976 [1776]: 733)

British trading companies mismanaged and confined the branches of trade in question, and consequently they became 'burdensome or useless' (Smith 1976 [1776]: 733).

The expenses of the education of youth could be defrayed by the general revenue or public endowments. However, Smith argued that, in order to ensure high standards of teaching, the cost of education should be covered by the fee or honorary which students paid to their university or school. This proposal did not mean that the government could be unconcerned about the education of the people. Governments in a civilized society had to educate the common people, who were apt to lose their skills and virtues because of the division of labour:

> In the progress of the division of labour, the employment of the far greater part of those who live by labour, that is, of the great body of the people, comes to be confined to a few very simple operations, frequently to one or two. . . . [A worker's] dexterity at his own particular trade seems . . . to be acquired at the expense of his intellectual, social, and martial virtues. But in every improved and civilized society this is the state into which the labouring poor . . . must necessarily fall, unless government takes some pains to prevent it.
>
> (Smith 1976 [1776]: 781–2)

Education would also prevent people from judging the government rashly or captiously due to the ignorance and stupidity. Smith maintained that the cost of primary education of the common people had to be supported by the government.

Expenses for the instruction of people of all ages meant mainly those for religious instruction:

> The teachers of the doctrine which contains this instruction . . . may either depend altogether for their subsistence upon the voluntary contributions of their hearers, or they may derive it from some other fund to which the law of their country may entitle them.
>
> (Smith 1976 [1776]: 788)

However, stating that '[t]heir exertion, their zeal and industry, are likely to be much greater in the former situation than in the latter' (Smith 1976 [1776]: 788), Smith concluded that religious institutions could be supported better by voluntary contributions than by the general revenue. Moreover, Smith did not think that religious institutions had to have large revenue.[9]

With respect to the expenses of supporting the dignity of the sovereign, Smith briefly commented that they were necessary and had to increase as society became wealthier, that they would be greater in a monarchy than in a republic, and that they could be defrayed by the general revenue (Smith 1976 [1776]: 814).[10]

Thus, expenses which had to be covered by the general revenue alone were those for defence and the dignity of the sovereign. Other public services could be supported for the most part by the payments of people who benefited from the service. If the beneficiaries' payments could not cover the whole expense of public services, the deficiency had to be made up by general revenue. It must be stressed that Smith regarded the expense of defence as the main expense which the general revenue had to cover. Because defence contributed to the benefit of the whole society, the general revenue had to be collected 'as nearly as possible, in proportion to [people's] respective abilities' (Smith 1976 [1776]: 814).

3.3.2 Taxation[11]

Smith thought that in a civilized state, the general revenue had to be financed by taxes imposed on the subjects, rather than from stock and lands which the government possessed. Smith believed that '[n]o two characters seem more inconsistent than those of trader and sovereign' (Smith 1976 [1776]: 819). Because, in general, stock and land would be used more efficiently by self-interested traders than the government, state-owned land and state-owned stock should be sold to private citizens as much as possible. By imposing taxes on private revenue, the government could gain a larger public revenue than by direct management of land and stock. Thinking in this way, Smith devoted most of Chapter 2 of Book 5, 'Of the Sources of the general or publick Revenue of the Society', to the issue of taxation.

According to Smith, every tax would ultimately fall on one or more of three private revenues – the rent of land, the profit of capital, and the wages of labour. Smith considered taxes imposed on each of these revenues individually, as well as taxes imposed indifferently on them – for example, taxes on raw produce (i.e. agricultural produce), manufactured necessities and manufactured luxuries. Smith examined the effects of every tax on the 'natural rates' of rent, profit, and wages – discussed in detail in Book 1 – although he did not explicitly use this term in Book 5. Whereas the natural price of raw produce was composed from the natural rates of rent, profit, and wages, the natural prices of manufactured necessities and manufactured luxuries were composed of the natural rates of profit and wages. Smith indicated effects of a tax on the natural prices of commodities towards which market prices would converge.[12]

Smith made explicit the four maxims of taxation, which he had already used in *Lectures on Jurisprudence* – 'equality', 'certainty', 'convenience', and 'economy'. Of these four maxims, 'equality' was defined as follows:

> The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.
>
> (Smith 1976 [1776]: 825)

This definition could be regarded as a conflation of the benefit approach and the ability-to-pay approach. It did not directly refer to 'equity' or 'neutrality' of a tax burden between social classes. Smith stated that he would not handle inter-sectoral equality in detail:

> Every tax, it must be observed once for all, which falls finally upon one only of the three sorts of revenue above-mentioned, is necessarily unequal, in so far as it does not affect the other two. In the following examination of different taxes I shall seldom take much further notice of this sort of inequality, but shall, in most cases, confine my observations to that inequality which is occasioned by a particular tax falling unequally even upon that particular sort of private revenue which is affected by it.
>
> (Smith 1976 [1776]: 825)

Despite his proviso, Smith was not indifferent to the effects of taxation on the relative condition of each class. In fact, Smith paid much attention to the problem of whether a tax would become a burden on the lower income classes. However, Smith rejected devoting himself to a simple class-conflict thesis of the sort which later captured Ricardo.[13]

Smith attached more importance to the certainty of tax revenue than to its equality:

> The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.
>
> (Smith 1976 [1776]: 826)

The maxim of 'convenience' referred to the time and the manner in which a tax was paid. The maxim of 'economy' considered: (1) the cost of collection; (2) a distortion of the natural allocation of resources; (3) punishments for tax evasion and smuggling; and (4) inspections by tax gatherers. These would produce a greater loss in the people than their payment to the public treasury.

On the basis of these four maxims, Smith examined the incidence and effects of every tax. The general purpose of his tax incidence theory was to refute the Physiocrats' doctrine that agriculture was the sole source of wealth:

> All taxes, [the Physiocrats] pretend, fall ultimately upon the rent of land, and ought therefore to be imposed equally upon the fund which must finally pay them. ... But without entering into the disagreeable discussion of the metaphysical arguments [on the source of wealth] by which they support their very ingenious theory, it will sufficiently appear from the following review, what are the taxes which fall finally upon the rent of the land, and what are those which fall finally upon some other fund.
>
> (Smith 1976 [1776]: 830)

Smith took it for granted that a tax levied on the rent of land would be paid by the landlord alone. This conclusion rested on Smith's definition of rent shown in Chapter 11 of Book 1:

> RENT, considered as the price paid for the use of land, is naturally the highest which the tenant can afford to pay in the actual circumstances of the land. In adjusting the terms of the lease, the landlord endeavours to leave him no greater share of the produce than what is sufficient to keep up the stock from which he furnishes the seed, pays the labour, and purchases and maintains the cattle and other instruments of husbandry, together with the ordinary profits of farming stock in the neighbourhood. ... This portion, however, may still be considered as the natural rent of land, or the rent for which it is naturally meant that land should for the most part be let.
>
> (Smith 1976 [1776]: 160)

In Smith's natural price system, rent was defined as the surplus part of the price of raw produce; in other words, the residuum of the price after profit and wages were subtracted. Moreover, rent did not determine the price of raw produce, but was determined by it:

> Rent, it is to be observed, therefore, enters into the composition of the price of commodities in a different way from wages and profit. High or low wages and profit, are the causes of high or low price; high or low rent is the effect of it.
>
> (Smith 1976 [1776]: 162)[14]

Because rent played a role as a buffer, a tax on rent would not be shifted onto profit, wages, nor the price of raw produce.

The land tax in England – which was imposed on the fixed value of rent – was a certain, convenient, and economical tax. In particular, it would not influence the improvement of land. However, the fixed land tax was unequal, because rent varied unevenly between lands. In order to correct this inequality in the English land tax, Smith proposed to change it into a variable land tax of the sort which the Physiocrats recommended, that is, '[a] tax upon the rent of land which varies with every variation of the rent, or which rises and falls according to the improvement or neglect of cultivation' (Smith 1976 [1776]: 830). The discouragement to the improvement of land which a variable land tax gave could be avoided by exempting the cost incurred in improving the land: this exemption rule would rather encourage the improvement of land. Certainty of revenue would be maintained by obliging the landlord and the tenant to record their lease in a public register. The increase in the cost of collection would not be large, and would definitely be less than the increase in tax revenue. For these reasons, Smith proposed a variable land tax in order to increase the general revenue of the British government, as well as to correct the inequality in the existing land tax. The variable land tax, stated Smith, would be 'much more proper to be established as a perpetual and unalterable regulation, or as what is called a fundamental law of the commonwealth' (Smith 1976 [1776]: 834).[15]

A tax on the rent of a house – composed of the building and the ground rent – would be paid first by the inhabitant. However, because demand for houses would diminish, and supply would be adjusted to demand in the long run, the ground rent would fall. The tax would be ultimately incurred partly by the inhabitant of the house and partly by the owner of the ground, although '[i]n what proportion this final payment would be divided between them it is not perhaps very easy to ascertain' (Smith 1976 [1776]: 842). The part of a house tax that the inhabitant incurred could be regarded as an expenditure tax, because the amount spent on a house would demonstrate most exactly his liberality or frugality. Smith suggested a progressive tax on the rent of houses:

> A tax upon house-rents, therefore, would in general fall heaviest upon the rich; and in this sort of inequality there would not, perhaps, be anything very unreasonable. It is not very unreasonable that the rich should contribute to the publick expense, not only in proportion to their revenue, but something more than in that proportion.
>
> (Smith 1976 [1776]: 842)[16]

Smith did not consider it unjust that a house tax would fall partly on the ground owner. The ground rent, as well as the rent of agricultural land, was fit for a special tax, because it was unearned income:

> Both ground-rents and the ordinary rent of land are a species of revenue which the owner, in many cases, 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. . . . Ground-rents and the ordinary rent of land are, therefore, perhaps, the species of revenue which can best bear to have a peculiar tax imposed upon them.
>
> (Smith 1976 [1776]: 844)[17]

Thus, Smith proposed a special tax on the ground rent of a house, although he did not explain how to distinguish a ground rent from a building rent. A house tax would act as a special tax on the ground rent.[18]

According to Smith, whereas a tax imposed on property remaining in the possession of the same person would be paid by revenue arising from it, a tax levied on a transference of property would diminish a part of its capital value. This kind of tax – typically taking the form of stamp duties – violated the fourth maxim of taxation (economy), because it would 'diminish the funds destined for the maintenance of productive labour' (Smith 1976 [1776]: 862). A tax on a transference of property was also unequal, because it would be levied in proportion to the frequency of transference, not the value, of property. Probably for these reasons, Smith put forward no positive suggestions for the reform of British inheritance taxes, which were imposed on movable property alone.

Smith also discussed a tax imposed on the profit of capital. According to Smith, a 'natural' or 'ordinary' rate of profit was 'every where regulated by the quantity of stock to be employed in proportion to the quantity of the employment, or of the business which must be done by it' (Smith 1976 [1776]: 848). If the proportion between the aggregate quantity of capital and the aggregate demand for capital was not affected by taxes, the rate of profit could be treated as constant. In fact, Smith treated the incidence and effects of taxes as if this had been the case.

Profits were composed of two elements: the interest of the owners of capital; and the compensation of the users of capital for the risk and inconvenience of employing capital. The interest of money was an unsuitable subject for a direct tax, because the amount of money capital which an individual possessed could hardly be ascertained (Smith 1976 [1776]: 848). Moreover, the users of capital could not shift a tax levied on profits onto the interest, because the owners of capital would withdraw their money and export it to foreign countries. Consequently, in order to maintain their ordinary rate of profit, the users of capital would shift the tax onto others. Smith concluded that if the users of capital were manufacturers, they would raise the price of manufactures; and that if they were farmers, they would pay less rent (Smith 1976 [1776]: 847). This conclusion stemmed from Smith's asymmetric assumption about the mobility of capital in the agricultural and manufacturing sectors. With respect to the manufacturing sector, Smith argued:

> When a tax is imposed upon the profits of stock in a particular branch of trade, the traders are all careful to bring no more goods to market than what they can sell at a price sufficient to reimburse them for advancing the tax. Some of them withdraw a part of their stocks from the trade, and the market is more sparingly supplied than before. The price of the goods rises, and the final payment of the tax falls upon the consumer.
>
> (Smith 1976 [1776]: 855–6)

The manufacturers could shift the burden of the tax on profits onto consumers by raising the price of their commodity. It must be stressed that the increase in the price of the commodity taxed was accompanied by a decrease in demand for it.

In contrast to manufacturers, farmers could not raise the price of raw produce by withdrawing their capital. Smith explained the reason as follows:

> Each farmer occupies a certain quantity of land, for which he pays rent. For the proper cultivation of this land a certain quantity of stock is necessary; and by withdrawing any part of this necessary quantity, the farmer is not likely to be more able to pay either the rent or the tax. In order to pay the tax, it can never be in his interest to diminish the quantity of his produce, nor consequently to supply the market more sparingly than before. The tax, therefore, will never enable him to raise the price of his produce so as to reimburse himself by throwing the final payment upon the consumer.
>
> (Smith 1976 [1776]: 856)

Because the farmers' capital was inseparable from a fixed acreage of land, they could not withdraw a part of it.[19] Were they to do so, they would lose all their produce. However, they would have to get the same rate of profit as the manufacturers. This would be possible only if they were able to pay less rent. The farmers would shift the burden of the tax onto the landlords. Consequently, a general tax on profits would ultimately fall on consumers and landlords. The price of manufactures would rise compared to the price of raw produce, and the rent of land would fall.

There is a problem in this explanation. If the total amount of capital had to be constant, and the demand for manufactures was elastic, capital would move from the manufacturing sector to the agricultural sector. This capital movement would affect the total amount of rent. However, Smith did not consider such an effect.

Smith did not think that a tax levied on wages would be incurred by labourers. The conventional subsistence of labour depended on the dynamic demand for labour and the population growth:

> The demand for labour, according as it happens to be either increasing, stationary, or declining; or to require an increasing, stationary, or declining population, regulates the subsistence of the labourer, and determines in what degree it shall be, either liberal, moderate, or scanty.
> (Smith 1976 [1776]: 864)

If the growth of the demand for labour – compared with the growth in population – was not influenced by taxes, the conventional subsistence of labour (or the real wage rate) could be treated as constant. In fact Smith assumed this in Book 5. A tax on wages would raise money wages, and the burden would fall on the employers of labourers.[20]

The employers of labourers, if they were manufacturers, would shift the burden of the tax by increasing the price of manufactures. If they were farmers, however, they would not raise the price of raw produce; they would pay less rent to the landlords. Thus, a tax on wages would produce the same qualitative effect as a tax on profits: the tax would finally fall on consumers and landlords (Smith 1976 [1776]: 864–5).[21]

Of indirect taxes, taxes upon the produce of land were in reality taxes on the rent: although they would be paid initially by the farmer, they would finally fall on the landlord (Smith 1976 [1776]: 836–7). Because a farmer's capital was inseparable from a fixed acreage of land, the farmer was not able to diminish production without a loss by withdrawing a part of his capital. Consequently, the price of the commodity taxed would not rise. Although the farmer would incur the tax during the current lease, he would recover the ordinary profit by paying less rent at the renewal of the lease. The rent of land – as a buffer – had to incur the burden. Smith thought that this kind of tax – for example, the English tithe – was an unequal tax on rent, because it was imposed in proportion to the produce of the land – not rent. The landlords who received only a small rent could not afford to pay the tithe. In contrast to the variable land tax, the tithe would discourage the improvement of land. For these reasons, Smith did not regard the tithe as a desirable tax.

Taxes on luxuries were more desirable than taxes on such necessities as salt, soap, leather, and candles. Taxes on necessities would raise the wages of labour, and consequently raise the price of all manufactures: rent would decrease. 'It is thus that a tax upon the necessaries of life operates exactly in the same manner as a direct tax upon the wages of labour' (Smith 1976 [1776]: 871). Whereas labourers were compensated for taxes on necessities, landlords had to incur the burden of the tax in the form of a reduction of nominal rent and of a decrease in the real purchasing power of rent. Capitalists would also have to carry the burden of the tax as consumers of manufactures. Smith warned the middle and upper classes:

> The middling and superior ranks of people, if they understand their own interest, ought always to oppose all taxes upon the necessaries 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. They fall heaviest upon the landlords, who always pay in a double capacity; in that of landlords by the reduction of their rent, and in that of rich consumers by the increase of their expence.
>
> (Smith 1976 [1776]: 873)[22]

In contrast to taxes on necessities, taxes on luxuries 'had no tendency to raise the price of any other commodities except that of the commodities taxed' (Smith 1976 [1776]: 873).[23] They would be incurred by the consumers alone. Whereas the taxes on luxuries violated the maxim of equality, because they were imposed in proportion to one's liberality – not ability to pay – they satisfied the maxims of certainty and convenience. The taxes on luxuries could sometimes contradict the maxim of economy, because of their collection cost, the disturbance given to industry, the cost of inspections by a tax gatherer, and smuggling. Smith thought that in general the British system of excise suffered less from these faults than any of the other European countries. However, Smith proposed to consolidate the existing taxes on malt, beer, and ale into a single tax on malt, arguing that this reform would make the excise system more efficient and produce a larger revenue.

Customs duties on foreign commodities would be paid by consumers. If the commodity taxed was a luxury good, the tax would not be shifted. However, if the commodity taxed was a necessity, the tax would produce the same incidence as a tax on domestic necessities. Middling and superior ranks of people would finally have to incur the burden.

Heavy customs duties – imposed for the purpose of giving domestic producers a monopoly power – not only disturbed the natural development of domestic industries but also reduced government revenue by diminishing importation of the commodity taxed and by promoting smuggling. Smith criticized the mercantile system in Britain – which he described in detail in Book 4 – from the viewpoint of government revenue as well as national prosperity:

> That the mercantile system has not been very favourable to the revenue of the great body of the people, to the annual produce of the land and labour of the country, I have endeavoured to shew in the fourth book of this Inquiry. It seems not to have been more favourable to the revenue of the sovereign; so far at least as that revenue depends upon the duties of customs.
>
> (Smith 1976 [1776]: 881)

In order to make the system of customs duties more efficient, Smith proposed to limit them to a few foreign luxuries which were widely consumed by the people; for example, wines, brandies, sugar, rum, tobacco, cocoa-nuts, tea, coffee, and spices. Smuggling could be avoided by establishing a warehouse system. Thus, Smith revived Walpole's scheme of customs reform, which had been finally withdrawn because of popular aversion to a general excise.[24]

Smith's theory of tax incidence can be summarized as follows: (1) a tax on the rent of land and a tax on raw produce would reduce the rent, maintaining the prices of all kinds of commodities; (2) a tax on the rent of houses would fall on the inhabitant and the ground owner, although the proportion of the incidence between them would be indefinite; (3) taxes on manufactured necessities, on wages, and on profits would reduce the rent of land, raising the prices of manufactures relative to the price of raw produce; (4) a tax on manufactured luxuries would only increase their price; (5) a customs duty would have the same effect on a tax on luxuries or necessities, depending on the nature of the commodity taxed. These conclusions stemmed from Smith's asymmetric assumptions that any increase in the production costs (including profits) of raw produce would be absorbed by a reduction in the rent of land, and that any similar increase in the costs of manufactured commodities would raise their price.[25] Consequently, all taxes, except a tax on luxuries, would reduce the rent of land. Because landlords were the main consumers of luxuries, a tax on luxuries would also diminish the real purchasing value of rent.

Thus, Smith's theory of tax incidence concluded that landlords were the main taxpayers. Although Smith's theory was not founded on a Physiocratic view of the source of wealth, his conclusions on tax incidence did not differ greatly from theirs.[26] It indicated that the landlords would benefit most from more efficient public finance, to be realized by tax reforms and retrenchment.

Smith summarized his tax-reform scheme as follows:

> A more equal land-tax, a more equal tax upon the rent of houses, and such alterations in the present system of customs and excise as those which have been mentioned . . . might, perhaps, without increasing the burden of the greater part of the people, but only distributing the weight of it more equally upon the whole, produce a considerable augmentation of revenue.
>
> (Smith 1976 [1776]: 933)[27]

Without this reform, and with the growing public debt, taxes would have to increase and reach all necessities of life. However, heavy taxes on necessities would not only oppress landlords, but also destroy the principal manufactures in Britain as had occurred in Holland.[28] In order for Britain not to follow the same course as Holland, the existing system of taxation had to be reformed. However, such a reform would not be enough to cover the growing public debt. If this were the case, other sources of revenue would have to be found, or public retrenchment carried out.

3.3.3 Public debt

Smith thought that perpetual (or long-term) public debt had become popular in Britain and other European states because 'by the practice of perpetual funding [governments] are enabled, with the smallest possible increase of taxes, to raise annually the largest possible sum of money' (Smith 1976 [1776]: 920). However, because the debt was perpetual, the taxes mortgaged for the interest of debt were also perpetual. Consequently, the people were not released from the tax burden even after the war for which a large debt was contracted. If government revenue produced surplus, it could be converted into a sinking fund for paying off the debt. However, the sinking fund was usually not enough to redeem public debt, and it was almost always applied to other purposes. Moreover, the sinking fund increased the amount of debt, because it was often mortgaged for contracting new debts. In Smith's view, it was not surprising that extravagant governments in the civilized countries accumulated huge public debt, and that the people's life was gradually depressed by heavier taxes.

Smith rejected the view that public debt was a part of national capital:

> the capital which the first creditors of the publick advanced to government, was ... a certain portion of the annual produce turned away from serving in the function of a capital, to serve in that of a revenue; from maintaining productive labourers to maintain unproductive ones, and to be spent and wasted, generally in the course of the year, without even the hope of any future reproduction.
>
> (Smith 1976 [1776]: 924)

Whereas government expenditure financed by taxation transferred unproductive consumption from the private sector to the public sector, public debt would consume productive capital. Concerning the macroeconomic effects of taxation and public debt, Smith maintained the 'supply-side' view put forward in the *Lectures on Jurisprudence*.

Smith also rejected the argument that the payment of the interest on public debt was a mere transfer from the right hand to the left. Considering that public debt would transfer revenue from landlords and capitalists to public creditors, Smith argued as follows:

> To transfer from the owners of those two great sources of revenue, land and capital stock, from the persons immediately interested in the good condition of every particular portion of land, and in the good management of every particular portion of capital stock, to another

> set of persons (the creditors of the publick, who have no such particular interest), the greater part of the revenue arising from either must, in the long-run, occasion both the neglect of land, and the waste or removal of capital stock.
>
> (Smith 1976 [1776]: 928)

Thus, Smith concluded that '[t]he practice of funding has gradually enfeebled the state which has adopted it' (Smith 1976 [1776]: 928), referring to the Italian republics, Spain, and Holland, as examples of declining states because of public debt. To Smith, it was a serious possibility that Britain would follow these states. In fact it was very difficult for any state to pay off its debt:

> When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and compleatly paid. The liberation of the publick revenue, if it has ever been brought about at all, has always been brought about by bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment.
>
> (Smith 1976 [1776]: 929)

Whereas 'avowed bankruptcy' meant Hume's 'natural death of public credit', 'real bankruptcy' (or 'a pretended payment') was consistent with 'death by the doctor'. A pretended payment was practised by raising the denomination of the coinage or by adulterating the coinage. Both methods of real bankruptcy were obviously unjust: in particular an adulteration of the coinage was an unjust and treacherous fraud. Moreover, these methods would raise the general price level. Although the real burden of interest payments on public debt would be reduced, the condition of private borrowers – idle and extravagant people – would be improved by the sacrifice of private creditors – industrious and frugal people. Thus, 'real bankruptcy' would violate the principle of justice, destroy public and private credit, and impede economic growth. For these reasons, Smith argued:

> When it becomes necessary for a state to declare itself bankrupt, . . . a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor. The honour of a state is surely very poorly provided for, when, in order to cover the disgrace of a real bankruptcy, it has recourse to a juggling trick of this kind, so easily seen through, and at the same time so extremely pernicious.
>
> (Smith 1976 [1776]: 930)[29]

Following Hume, Smith preferred avowed bankruptcy to real bankruptcy. However, in contrast to Hume, Smith did not support avowed bankruptcy as the best method of clearing the public debt. By such a policy, the government would lose political support from the moneyed interest. Faithful payment of interest on public debt – as well as regular redemption of the capital through a sinking fund – was a necessary condition of liberal and commercial society. Keeping to the position set out in *Lectures on Jurisprudence*, Smith examined how the British government could raise surplus revenue, or at least reduce the budget deficit.

An increase in the existing taxes would be the simplest way of raising revenue. Smith believed that the British tax system 'has hitherto given so little embarrassment to industry' (Smith 1976 [1776]: 929), because

> during the course even of the most expensive wars, the frugality and good conduct of individuals seem to have been able, by saving and accumulation, to repair all the breaches which the waste and extravagance of government had made in the general capital of the society.
>
> (Smith 1976 [1776]: 929)

However, despite this fact, Smith could not help adding that '[l]et us not . . . upon this account rashly conclude that [Britain] is capable of supporting any burden; nor even be too confident that she could support, without great distress, a burden a little greater than what has already been laid upon her' (Smith 1976 [1776]: 929). Hence a mere increase in the existing taxes would not be effective. In order to raise revenue without imposing further burdens on the people, the British government had to either (1) reform the existing tax system, or (2) extend the tax system to all provinces of the empire, or (3) reduce government expenditure, particularly on defence of the colonies.

As shown above, Smith proposed to reform the British tax system, in particular with respect to the land tax, the house tax, excises and customs duties. However, Smith did not think such reforms would produce a large additional revenue:

> The most sanguine projector . . . however, could scarce flatter himself that any augmentation of this kind would be such as could give any reasonable hopes, either of liberating the public revenue altogether, or even of making such progress towards that liberation in time of peace, as either to prevent or to compensate the further accumulation of the public debt in the next war.
>
> (Smith 1976 [1776]: 933)

Thus, tax reform had to be supplemented by other measures. Smith indicated that the British system of land taxes, stamp duties, excises and customs duties could be applied – with some modifications – to her different provinces such as Ireland, the West and East Indies, and the American colonies. It was not unjust to make the provinces share the defence costs of the empire, if a representation to the Parliament was given to each province in proportion to the amount of tax it shared. However, this scheme would meet a political difficulty in both sides of Britain and the colonies. Smith thought that '[t]he private interest of many powerful individuals, the confirmed prejudices of great bodies of people seem, indeed, at present, to oppose to so great a change such obstacles as it may be very difficult, perhaps altogether impossible, to surmount' (Smith 1976 [1776]: 933–4). In fact, the recent revolt of the American colonies was provoked by the British Parliament's attempt to exercise powers of taxation over them. Although Smith put forward in detail a revised scheme of imperial taxation, he intended it only as a kind of utopia.[30]

If a tax reform in Britain did not produce sufficient revenue, and if the British tax system could not be extended to the empire, 'the only resource which can remain to her is a diminution of her expence' (Smith 1976 [1776]: 946). The expenses of defence – as well as the debt charge – occupied a large proportion of government expenditure. Of these expenses, the expense of retaining an army for the defence of the mother country during times of peace was lower in Britain than in any other European state: there was no room for reducing this kind of expense. In contrast, the expense of retaining an army for the defence of the colonies in times of peace was 'very considerable, and is an expence which may, and if no revenue can be drawn from them, ought certainly to be saved altogether' (Smith 1976 [1776]: 946). Moreover, the expense of the war establishment for the defence of the colonies was much larger.

The War of the Austrian Succession and the Seven Years War were undertaken by Britain in order to defend her colonies. A great part of the cost could have justly been charged to the colonies. However, because the taxation system did not make the colonies contribute to the general revenue, all the war costs became a burden to Britain, and consequently increased her public debt. To Smith, the colonies were 'appendages, as a sort of splendid and showy equipage of the empire' (Smith 1976 [1776]: 946). Because the American colonies had already begun to revolt against Britain, and the scheme of imperial taxation was only an ideal, voluntary separation of the American colonies would be the most practical – if not best – solution. The *Wealth of Nations* concluded with the following sentence:

> If any of the provinces of the British empire cannot be made to contribute towards the support of the whole empire, it is surely time that Great Britain should free herself from the expence of defending those provinces in time of war, and of supporting any part of their civil or military establishments in time of peace, and endeavour to accommodate her future views and designs to the real mediocrity of her circumstances.
>
> (Smith 1976 [1776]: 947)

Separation from the American colonies would supply the state with surplus revenue sufficient to pay off the public debt, defray other public services, and reduce taxes. Consequently, the people would be relieved of heavy taxes, and, unless oppressive regulations were imposed on trade and industry, domestic manufactures would grow faster. Thus, voluntary separation was consistent with the limitations which Smith put on government expenditure: to limit it so that private frugality and effort could cover the loss of national wealth. It also fitted two of the objects of political economy: to supply revenue to the people, as well as the sovereign.

3.4 Conclusion

Smith considered the subject of public finance as an important branch of the science of legislator, not only because it was at the intersection of jurisprudence and political economy, but also because it constituted one of the two main objects of political economy. This concept of public finance was introduced first in *Lectures on Jurisprudence*, and retained in the *Wealth of Nations*.

Smith took a supply-side view of the macroeconomic effects of government expenditure, taxation, and public debt: government expenditure was unproductive from the viewpoint of capital accumulation; taxes disturbed the people's industrial activities, depending on the manner of imposition; public debt always destroyed productive capital; and the payment of interest transferred revenue from the industrious to the unproductive classes.

The chapter on government expenditure in the *Wealth of Nations* argued that defence was the main public service which had no other sources than general revenue: it meant that an increase in the expense of defence would always increase public debt and/or taxes. This conclusion was the basis of the later argument with respect to retrenchment: a reduction in the expense of defence would be the most effective way to produce surplus revenue. A prudent legislator could examine whether there was an excessive expenditure on defence. This was the essence of Smith's views on the management of government expenditure.

In order to establish a fairer and more efficient system of taxation in Britain, Smith proposed several reforms of the land and house taxes, as well as customs and excise duties. However, such a proposal only made clear that there was little room for the government to raise additional revenue from domestic taxes. These negative views gave Smith a good reason to insist on retrenchment.

Smith demonstrated that most taxes would reduce the rent of land, except for taxes on luxuries. Because the main consumers of luxuries were landlords, taxes on luxuries would also be paid mainly from rent. Thus, the principal taxpayers of the country were landlords. This conclusion implied that the landlords – men of power in the Parliament – would receive most benefit from public retrenchment. Landlords who had read carefully the chapter on taxation of the *Wealth of Nations* would have approved of reducing government expenditure.

Smith's chapter on public debt – the final chapter of the *Wealth of Nations* – argued that unless retrenchment were carried out, the growing public debt would ruin the principal manufactures in Britain. Tax reform, Smith suggested, would not produce a sufficient revenue, and imperial taxation would be politically unfeasible. Of means of retrenchment, the most effective would be a reduction of the cost of defence if it exceeded what was necessary. Smith thought that, to Britain, expenditure on the colonies was the same as the consumption of luxuries. Although such expenditure could maintain the dignity of the sovereign, it would cost the nation too much, and make government expenditure exceed its limits. Smith concluded that the British people could benefit – rather than lose – by abandoning the American colonies.

Voluntary separation would produce surplus revenue, pay the interest on the public debt, pay off redeemable debts, and consequently prevent taxes from being imposed on the necessities of life. Without heavy taxes and oppressive regulations, British trade and industry would grow faster. Thus, Smith's opinions on voluntary separation were founded on a consistent account of government expenditure, taxation, and public debt. These opinions could be regarded as his answer to the problems raised by Hume.

However, Smith's conclusion that most (if not all) taxes would ultimately fall on the rent of land partly undermined his argument that government expenditure would transfer resources from their productive to unproductive use: this might simply transfer unproductive consumption from landlords to the government. Such a conclusion stemmed from his assumption that whereas manufacturers could move their capital freely, farmers' capital was joined to a fixed acreage of land. Consequently, whereas manufacturers could shift taxes onto the price of their commodities, farmers could not do so. Because the rent of land played a role as a buffer in the price of raw produce, landlords would have to incur the burden of the taxes imposed on farmers. However, how could landlords who received less rent than the amount of those taxes pay them?[31] What would happen if farmers' capital could move as freely as manufacturers'? Was it possible to emphasize the unproductiveness of government expenditure more strongly, by indicating that most taxes would ultimately fall on the profits of capital, the true driving force of capital accumulation? As will be discussed in Chapter 6, these questions were raised by Ricardo, and Smith's view of public finance was re-examined by a stricter theory.

Notes

1 James Mill's letter to Ricardo, 16 December 1816.
2 Smith did not directly refer to the issue of taxation and public debt in *Theory of Moral Sentiments* (1759).

3 Smith's influence may explain why Hume attached the following sentences to the 1770 edition of *Political Discourses*: 'The immense greatness, indeed, of London, under a government which admits not of discretionary power, renders the people factious, mutinous, seditious, and even perhaps rebellious. But to this evil the national debts themselves tend to provide a remedy. The first visible eruption, or even immediate danger, of public disorders must alarm all the stockholders, whose property is the most precarious of any; and will make them fly to the support of government, whether menaced by Jacobitish violence or democratical frenzy' (Hume 1987 [1752]: 355). Winch (1978: 130) argues that 'the very fact that both Hume and Smith recognized the potential contribution to public order made by the diffusion of debt ownership marks a departure in the "Court" direction from the oppositional literature of the earlier part of the century, where the growth of the moneyed interest was treated largely as a threat to liberty'.

4 Smith did not use the dichotomy of 'productive labour' and 'unproductive labour' in *Lectures on Jurisprudence*, although he thought that government expenditure would retard economic growth.

5 Winch (1978: 131) indicates that the terms 'productive labour' and 'unproductive labour' are not essential as a basis for Smith's observation on public prodigality, arguing that 'they have contributed powerfully to Smith's *laissez-faire* image – an image which does not prepare the reader for the fairly tolerant attitude towards the expenses of the sovereign adopted in Book V of the *Wealth of Nations*'.

6 However, Smith thought that the government should support military exercises of the people in order to prevent their martial spirit from decaying: 'where every citizen had the spirit of a soldier, a smaller standing army would surely be requisite. That spirit, besides, would necessarily diminish very much the dangers to liberty, whether real or imaginary, which are commonly apprehended from a standing army' (Smith 1976 [1776]: 787).

7 The section 'Of the Publick Works and Institutions which are necessary for facilitating particular Branches of Commerce' appeared in the third edition (1784) of the *Wealth of Nations*.

8 Smith thought that public services whose benefits were confined to a specific district should be administered by the local government: 'Even those publick works which are of such a nature that they cannot afford any revenue for maintaining themselves, but of which the conveniency is nearly confined to some particular place or district, are always better maintained by a local or provincial revenue, under the management of a local or provincial administration, than by the general revenue of the state, of which the executive power must always have the management' (Smith 1976 [1776]: 730).

9 Smith argued that revenue accruing to the Church of England would diminish the fund to be spent on defence: 'The rent of land . . . is, according to some, the sole fund, and, according to others, the principal fund, from which, in all great monarchies, the exigencies of the state must be ultimately supplied. The more of this fund that is given to the church, the less, it is evident, can be spared to the state. It may be laid down as a certain maxim that, all other things being supposed equal, the richer the church, the poorer must necessarily be, either the sovereign on the one hand, or the people on the other; and, in all cases, the less able must the state be to defend itself' (Smith 1976 [1776]: 812).

10 Smith did not always insist on curtailing this type of expense, in particular on durables: 'Noble palaces, magnificent villas, great collections of books, statues, pictures and other curiosities, are frequently both an ornament and an honour, not only to the neighbourhood, but to the whole country to which they belong. Versailles is an ornament and an honour to France, Stowe and Wilton to

England. Italy continues to command some sort of veneration by the number of monuments of this kind which it possesses, though the wealth which produced them has decayed, and though the genius which planned them seems to be extinguished, perhaps from not having the same employment' (Smith 1976 [1776]: 347).

11 This section draws on Dome (1998).

12 For the relationship between the natural and market prices, see Smith (1976 [1776]: 72–81).

13 Winch (1978: 137) argues that Smith's declaration of disregarding inter-sectoral equality 'not only sets him apart from the later interest in class distribution associated with the name of David Ricardo, but distances him from much of the earlier oppositional literature concerning on conflicts between landowning and moneyed interests'.

14 According to Gee (1981), the common interpretation of Smith's theory of rent was that his theory was fundamentally confused, but prepared the way for the Ricardo's theory of differential rent. For example, see Douglas (1928), Buchanan (1929), Hollander (1973), and Samuelson (1977). However, Fine (1983: 138) demonstrates that Smith's notion of rent was Physiocratic rather than Ricardian: '[because of land ownership] capitalists must pay a rent to use land and this is the source of Smith's rent as a determining component part of price'. I agree with Fine in rejecting the view of Smith's concept of rent as a simple differential rent. However, Smith considered that rent would be determined by the price of raw produce.

15 Smith's scheme of a variable land tax was revived by J. S. Mill in the nineteenth century. See Section 8.4.2.2 (pages 191–3).

16 This text is evidence that Smith was prepared to entertain a distributive role for taxation. It is also evidence against Musgrave's opinion that 'the distribution issue was ... largely omitted from Book V [of the *Wealth of Nations*]' (Musgrave 1976: 296).

17 Smith thought that the ground rent was a more proper subject of peculiar taxation than the rent of agricultural land: 'The ordinary rent of land is, in many cases, owing partly at least to the attention and good management of the landlord. A very heavy tax might discourage too much this attention and good management. Ground-rents, so far as they exceed the ordinary rent of land, are altogether owing to the good government of the sovereign, which, by protecting the industry either of the whole people, or of the inhabitants of some particular place, enables them to pay so much more than its real value for the ground which they build their houses upon; or to make to its owner so much more than compensation for the loss which he might sustain by this use of it. Nothing can be more reasonable than that a fund which owes its existence to the good government of the state should be taxed peculiarly, or should contribute something more than the greater part of other funds, towards the support of that government' (Smith 1976 [1776]: 844). For Ricardo's criticism of a special tax on the ground rent, see Section 6.3.2.2 (pages 126–7).

18 Smith argued that although the window tax violated the first maxim of taxation (namely, equality), it satisfied other maxims, and that it would diminish the rent of houses. See Smith (1976 [1776]: 846–7).

19 Seligman (1969 [1927]: 147) calls Smith's – as well as Ricardo's – theory of tax incidence – the 'absolute theory', arguing that Smith assumed perfect transferability of capital and labour without any qualification. However, in contrast to Ricardo, Smith did not assume the transferability of capital invested in land, and this produced his main conclusion that most taxes would fall on the rent of land.

20 Rashid (1998: 106) credits Smith's assumption of fixed real wages in his discussion of tax incidence to John Locke and Sir Mathew Decker. Rosenbluth

(1969: 313–14) shows that in a Smithian long-run model, wages depend on the growth of demand for labour and the Malthusian population mechanism. According to the Malthusian mechanism, population growth would have to slow down in order for wages to rise because of a tax on wages. This would occur – although it would take time – for example because of an increase in infant mortality. However, Smith's argument about the incidence of a tax on wages did not rely on such a population mechanism.

21 Smith argued that capitation taxes levied upon the lower ranks of people have the same effect as a direct tax on wages (Smith 1976 [1776]: 869).

22 Smith continued to hold this view after the first edition of the *Wealth of Nations*. For example, in a letter to Sir John Sinclair of January 1786, Smith wrote: 'I dislike all taxes that may affect the necessary expenses of the poor. They, according to circumstances, either oppress the people immediately subject to them, or are repaid with great interest by the rich, *i.e.* by their employers in the advanced wages of labour. Taxes on the *luxuries* of the poor, upon their beer and other spirituous liquors, for example, as long as they are so moderate as not to give much temptation to smuggling, I am so far from disapproving, that I [l]ook upon them as the best of sumptuary laws' (Mossner and Ross 1977: 327).

23 Smith thought that labourers consumed some luxuries as well as necessities (Smith 1976 [1776]: 871). However, Smith did not argue that an increase in the price of luxuries because of taxes would raise wages.

24 With respect to Walpole's reform plan, Smith explained: 'It was the object of the famous excise scheme of Sir Robert Walpole to establish, with regard to wine and tobacco, a system not very unlike that which is here proposed. But though the bill which was then brought into parliament comprehended those two commodities only; it was generally supposed to be meant as an introduction to a more extensive scheme of the same kind. Faction, combined with the interest of smuggling merchants, raised so violent, though so unjust, a clamour against that bill, that the minister thought proper to drop it; and from a dread of exciting a clamour of the same kind, none of his successors have dared to resume the project' (Smith 1976 [1776]: 886).

25 For the mathematical treatment of these conclusions, see Dome (1998).

26 McCulloch argued that Smith's theory of tax incidence was influenced by the Physiocrats' doctrine, ultimately traceable to Locke: 'Quesnay, and even Adam Smith, regarded the rent of land as a peculiar product, originating in and depending upon the special bounty of nature to the agriculturists' (McCulloch 1995 [1845]: 53). See also McCulloch (1968 [1852]: 50 and 1975 [1863]: 61).

27 Kennedy (1964 [1913]: 136) indicates that Smith's influence was limited with respect to the actual reform of customs duties in the eighteenth century. Kennedy also argues that, despite Smith's warning, taxes on necessities were generally increased in the last quarter of the century (Kennedy 1964 [1913]: 146–7).

28 On the fiscal condition of Holland, Smith wrote: 'After all the proper subjects of taxation have been exhausted, if the exigencies of the state still continue to require new taxes, they must be imposed upon improper ones. The taxes upon the necessaries of life, therefore, the wisdom of that republic which, in order to acquire and to maintain its independency, has, in spite of its great frugality, been involved in such expensive wars as have obliged it to contract great debts' (Smith 1976 [1776]: 906).

29 See also Smith (1976 [1776]: 42–4).

30 Winch (1978: 154) interprets Smith's scheme of imperial union as 'one of making out the economic boundaries for an acceptable solution rather than as a piece of straightforward advocacy'. In other words, Smith 'was setting out the

stringent conditions that would have to be met if empire was to be made tolerable, without necessarily endorsing imperial union as a practicable solution' (Winch 1978: 154).

31 Ricardo argued that Smith's conclusion with respect to a tax imposed on the produce of land did not consider the following fact: 'since much capital is employed on the land which pays no rent, and since it is the result obtained by this capital which regulates the price of raw produce, no deduction can be made from rent' (Ricardo 1951–73 [1817], vol. 1: 225). Ricardo thought that such a tax would ultimately fall on profits.

4 Jeremy Bentham

4.1 Introduction

Jeremy Bentham, like Smith, combined his interests in moral science, jurisprudence, and politics with an interest in political economy. In *An Introduction to the Principles of Morals and Legislation* (1789), Bentham indicated that in the future he would write the complete system of legislation, which would include principles of legislation in (1) civil law, (2) penal law, (3) procedure, (4) reward, (5) constitutional law, (6) political tactics, and (7) international law, and that principles of legislation in matters of finance and political economy would constitute the eighth and ninth parts respectively.[1] Although this plan was never carried out, Bentham's views on the principles of legislation related to political economy were set out in *Manual of Political Economy* (1793–5) and *Institute of Political Economy* (1801–4).

Like other branches of legislation, the general end of political economy was the maximization of happiness in the community. This general end was divided into four subordinate ends: subsistence; security; abundance; and equality. In the 'Introduction' to *Institute of Political Economy*, Bentham described:

> The object of the present work is to enquire what is the most suitable course for the sovereign of a country to pursue on each occasion ... the maximum of happiness with reference to the several members of the community taken together. ... This object may be termed the general end or *end paramount*, with reference to certain other objects which, separately taken, are of less extent and of subordinate importance: I mean 1. subsistence, 2. security, 3. [abundance which comprises] enjoyment or opulence, [and] populousness, [4.] equality.
>
> (Bentham 1952–4 [1801–4], vol. 3: 307)

Although political economy was a study of national wealth, it had to submit itself to these subordinate ends. To Bentham, wealth was the means, and happiness the end.

Of the four subordinate ends, Bentham attached the most importance to security. Without security, wealth would not be produced, and consequently, subsistence and abundance would not be maintained. In contrast, if security was guaranteed, wealth would naturally increase, and subsistence and abundance would be realized. Thus, security was the necessary and sufficient condition for subsistence and abundance. The principle of legislation with respect to security was called 'the security-providing principle'. Because this principle applied not only to one's life and property, but also to one's expectations with respect to them, it could also be called 'the disappointment-preventing principle' (Stark 1952–4, vol. 1: 92).[2]

Equality was also an important element of happiness. Bentham acknowledged that '[t]he more nearly the actual proportion approaches to equality, the greater will be the total mass of happiness' (Bentham 1962 [1802], vol. 1: 305). Legislation with respect to political economy should be enacted on the basis of 'the equality-maximizing principle', or more properly 'the inequality-minimizing principle' (Stark 1952–4, vol. 1: 93). However, Bentham argued:

> When security and equality are in opposition, there should be no hesitation: equality should give way. The first is the foundation of life – of subsistence – of abundance – of happiness; every thing depends on it. Equality only produces a certain portion of happiness: besides, though it may be created, it will always be imperfect; if it could exist for a day, the revolutions of the next day would disturb it. The establishment of equality is chimera: the only thing which can be done is to diminish inequality.
>
> (Bentham 1962 [1802], vol. 1: 311)

Thus, security was more important than equality, because, whereas security was always the foundation of happiness, equality would improve it only partly and temporarily.

Security was not only the most important element of happiness, but also the most suitable object for governmental intervention:

> In listing over the four several subordinate ends of political action, we shall [find] a great difference in respect of the demand they respectively present for the interference of the legislator. *Security* is more especially and essentially his work: in regard to subsistence, opulence, and equality, his interference is comparatively unnecessary.
>
> (Bentham 1952–4 [1801–4], vol. 3: 311; emphasis in original)

Bentham's fundamental view of the principles of legislation with respect to political economy can be summarized as follows. First, the legislator should intervene in the economy mainly on the basis of the security-providing principle. Second, the legislator could also pursue the equality-maximizing principle only if it was consistent with the security-providing principle.[3]

In the period 1794–1801, Bentham wrote several plans of public finance – one for governmental interventions: *Proposal for a Mode of Taxation* (1794); *A Plan for Augmentation of the Revenue* (1794–5); *Supply without Burden, or Escheat vice Taxation* (1795);[4] *Proposal for the Circulation of a [New] Species of Paper Money* (1795–6); *Abstract or Compressed View of a Tract Intituled Circulating Annuities* (1800). Bentham wrote these plans in order to propose to the Chancellor of Exchequer a means to finance the war against France and reduce the outstanding public debt. After 1800, Bentham shifted his main concern from public finance to monetary regulation – another form of governmental intervention. *Paper Mischief [Exposed]* (1800–1) and *The True Alarm* (1801) examined this theme.

In this chapter, I will demonstrate that Bentham's plans of public finance, as well as monetary regulation, were consistent with his fundamental views on the principles of legislation which concerned political economy – the security-providing principle and the equality-maximizing principle.[5] The following section will examine Bentham's general view on taxation and his two plans to raise revenue by taxation: an extension of the escheat law, and a tax on the profits of bankers and stock dealers. I will reconstruct his order of preference with respect to the different forms of taxation, including the two just mentioned. In the third section, Bentham's Annuity Notes scheme – one of his plans to raise revenue by 'money-traffic' – will be discussed, and the reason why Bentham finally abandoned the Annuity Notes scheme and shifted his concern to monetary regulation will be explained.

4.2 Revenue by taxation[6]

4.2.1 The principles of taxation

Bentham laid down the following condition for assessing all government expenditure: 'To judge of the expediency and eligibility of any branch of [public] expenditure, compare the benefit of it with the burthen of a correspondent portion of the produce of the most burthensome tax' (Bentham 1952–4 [1801–4], vol. 3: 364). The pleasure to be realized by government expenditure had to be superior to the pain produced by the worst taxes that would have to be imposed in order to finance it. Usually, only government expenditure on security would satisfy such a condition. Thus, Bentham argued that '[t]axes are sacrifices made of wealth and opulence at the expence of enjoyment, to security in respect of defence, and security in respect of subsistence' (Bentham 1952–4 [1801–4], vol. 3: 363).

Even if government expenditure was limited to the purpose of security, taxes would reduce the means of enjoyment of those on whom they were imposed. The degree of reduction would depend on the modes of taxation. Bentham thought that the sacrifice of enjoyment to taxation had to be minimized: 'Finance operates *in toto* in diminution of wealth . . . the object or end in view is – to render the diminution as small as possible, and as pure as possible from collateral vexation, and inconvenience in every shape' (Bentham 1952–4 [1801–4], vol. 3: 363).

Bentham refused to use taxation for other purposes than raising revenue. To Bentham, the natural and only original object of taxation was 'revenue' (Bentham 1952–4 [1793–5], vol. 1: 257). Because taxes were paid at least partly from consumption, if the government added tax revenue to productive capital, national wealth would increase faster. However, according to Bentham, tax stimulation – to reduce consumption and increase production and/or savings – should not be the object of taxation. It was an injustice to force a man – when he wished to enjoy himself – to labour or save for his own benefit or for the sake of increasing another man's enjoyment. The choice between savings and consumption belonged to *sponte acta* – the case where the end had to be promoted by individuals without special interference by the government. From the government's point of view, such forced frugality was contained in *non-agenda*.

Thus, government expenditure should be limited to purposes of security, and the most important issue to which the legislator had to pay attention was minimizing the pains and evils associated with taxation. Moreover, the main purpose of taxation had to be to raise revenue. Bentham's criteria of taxation was clearly summarized in *General View of a Complete Code of Laws* (1820):

> *First object of finance* – to find the money without constraint – without making any person experience the pain of loss and of privation. *Second object* – to take care that this pain of constraint and privation be reduced to the lowest term. *Third object* – to avoid giving rise to evils accessory to the obligation of paying the tax.
>
> (Bentham 1962 [1820], vol. 3: 204: emphasis in original)[7]

It will be demonstrated below that Bentham applied these criteria throughout his proposals on tax reform.

4.2.2 An extension of the escheat law

Bentham proposed to Charles Long – William Pitt's Co-Secretary to the Treasury – two new financial measures which would provide the government with revenue without imposing a burden on the people: first, an extension of the existing law of escheat; and second, a tax imposed on bankers' and stock dealers' profits.

The first measure was precisely set out in his *Supply without Burden, or Escheat vice Taxation*. Bentham attempted to extend the existing law of escheat which applied only to landed property with no heir. Bentham's plan was: (1) that the government would confiscate all property in the case of intestate succession where there were no marriage-prohibited relations;

(2) that the government would share a half of the intestate property in the case of collateral inheritance; (3) that wills of parents would be effective only with respect to half the amount of their property; (4) that the property which had to be restored to the public would be converted into money through a public auction. Because people would not usually expect to inherit property except from their parents, and because people are usually eager to leave property only to their children, this new law could supply public revenue without causing great disappointment to the people. Thus, the new law of escheat could be justified by the security-providing principle. Annual revenue obtained from this new law was estimated at about two million pounds – one-tenth of government revenue at that time (Bentham 1952–4 [1795], vol. 1: 297–8).

Bentham was not bothered by the expected objection that his law of escheat would violate the natural right of inheritance:

> I know of no natural rights except what are created by general utility: and even in that sense it were much better the word were never heard of. All such language is at any rate false: all such language is either pernicious, or at the best an improper and fallacious way of indicating what is true.
>
> (Bentham 1952–4 [1795], vol. 1: 333)

To Bentham, a right was derived from a law – not nature – and a law had to be subservient to human feelings. Thus, Bentham could concentrate his attention on whether the new law of escheat would improve human feelings.

Although his proposal could be said to be an extension of the existing inheritance taxes, Bentham avoided using the term 'tax'. If a small part of a bequest was taken by the state under the name of a tax, the heir would feel pain because he would think that the whole of bequest originally belonged to himself. By contrast, if the law told him that the whole of bequest belonged to the public, and that he was permitted a half share of it, he would not feel the pain of losing his property. Thus, considering the influence of names upon people's feelings of expectation, the new measure of escheat had to be enforced in the form of a regulation, not a tax: this was indicated in the subtitle of the pamphlet, namely *Escheat vice Taxation*. Because the common law could not legitimately determine the pale to which such a regulation applied, the new law of escheat had to be a statute law (Bentham 1952–4 [1795], vol. 1: 324).

Revenue obtained through the new law of escheat could be used (1) to reduce public debt, (2) to abolish several taxes, (3) to pay interest on public debt, and (4) to pay current services. Considering uncertainty with respect to the amount of revenue, Bentham thought the first two uses more desirable than the last two uses. Because the new law would confiscate productive capital, as well as land and bonds, it could prevent national capital from growing. The law could prevent the growth of capital also by weakening parents' incentive to save. However, if the revenue raised by this law was spent to reduce public debt, capital accumulation would not be impeded, because the public creditors would invest the repaid money on productive capital. By contrast, if the revenue was spent on the payment of the interest on public debt or on current services, capital accumulation would be retarded, because the public creditors and the government would spend such money at least partly on consumption. Therefore, from the viewpoint of capital accumulation, it was most desirable that the revenue raised by the new law of escheat was used to pay off public debt. However, Bentham did not stick to this use:

> Applied in lieu of taxes, applied to the payment of the interest of the debt, it certainly would act, as to the greatest part of it, in diminution of the national capital: but ought this part of its operation to be placed to the account of disadvantage? – By no means, but rather the contrary.
>
> (Bentham 1952–4 [1795], vol. 1: 359)

Bentham thought that a slowing of capital accumulation would prevent the rate of interest from declining rapidly, and that such a tendency would produce a beneficial psychological effect on the feelings of the people. Hence, revenue raised by the new law of escheat did not always have to be used to pay off public debt. It could be used – more desirably – to abolish burdensome taxes. Taxes on law proceedings, taxes on medicines, window tax, soap tax, and salt tax exemplified oppressive taxes to be abolished. These taxes were unjust, because they impeded justice, health, sanitation, and subsistence in people's lives, and because they distressed the poor more than the rich. If these taxes were taken away by revenue obtained from the law of escheat, people's utility would increase.

The new law of escheat would produce other effects: it would cut off a great source of litigation concerning inheritance; promote marriage; and raise asset prices (Bentham 1952–4 [1795], vol. 1: 289 and 344–6). Bentham thought that these effects would also improve people's feelings.

Thus, the new law of escheat could raise revenue without reducing utility, and could be used to increase it. Because of the law, property would be diffused more widely, and the poor would be relieved from burdensome taxes. Consequently, the new law would have a redistributive effect, which would improve the condition of the poor. This result would promote equality – without impeding security – and hence accord with the equality-maximizing principle. However, it must be noted that neither the diffusion of property nor improvements in conditions for the poor were the direct purpose of Bentham's escheat law. They were not shown even as indirect and remote effects to be expected from the proposed measures. Bentham emphasized that the new law of escheat would never mean a revolution in property: it would rather prevent a revolution.[8] Moreover, probably in order to make the government accept his proposal, Bentham indicated that the peerage would be exempted from the new law (Bentham 1952–4 [1795], vol. 1: 204).[9] Although the new law of escheat would be consistent with the equality-maximizing principle, the main purpose of Bentham's proposal in the 1795 pamphlet was – as the title showed – supply without burden, which was subject to the security-providing principle.[10]

4.2.3 A tax on profits with the exclusive privilege

The other financial measure which Bentham proposed was a tax on profits associated with monopoly or exclusive privilege. This proposal was explained in a pamphlet entitled *Proposal for a Mode of Taxation* and a broadsheet called *Tax with Monopoly*.

According to Bentham, 'it is the masters of the country that pay every thing, willing or unwilling' (Bentham 1952–4 [1794b], vol. 1: 381). Taxes fell most heavily on the landed class, whereas no tax was imposed on the interest of money lent, government and personal annuities, dividends paid by joint stock companies, profits from trade, and professional incomes. '[I]ndividuals of the numerous descriptions above mentioned can not, consistently with the rule of equality, be permitted to go altogether scot-free' (Bentham 1952–4 [1794b], vol. 1: 385). Bentham divided incomes into two groups. The first group included property incomes: rent from land; interest on money lent; government and personal annuities; and dividends paid by joint stock companies. The second group included industrial incomes: profits from trade; and professional incomes. Property income was assured income, but industrial income was casual income. Incomes had to be classified also from the viewpoint of whether they would continue after the life of the earner (perpetual income) or not (temporary income). Perpetual income could be inherited by children, but a man of temporary income 'must undergo a retrenchment adequate to the present maintenance and future establishment of those objects of necessary care' (Bentham 1952–4 [1794b], vol. 1: 386). However, because it was impracticable to accomplish equality in taxation by considering the differences between incomes, Bentham proposed to reduce the tax rate on industrial incomes to half that of property incomes.

Including this exemption rule, Bentham laid down the following general rules for income tax: (1) the subsistence income had to be exempted altogether; (2) the tax rate would gradually increase with respect to income from the subsistence level to the full sufficient level; (3) the tax rate would be fixed with respect to income above the full sufficient level; (4) compensation could be afforded unless it contradicted the public interest; (5) incomes eligible for compensation were to be taxed first, and ineligible incomes second (Bentham 1952–4 [1794b], vol. 1: 388). Following this general rule, Bentham looked for incomes which had not yet paid any direct tax, and on which the income tax could be imposed with compensation. Consequently, Bentham found profits of bankers and of stock dealers suitable for the tax. As compensation, bankers and stock dealers would be given an exclusive privilege – a limitation of their number through a licence system.

Bentham acknowledged the mischief of monopoly: it would decrease the supply; raise the price; impair the quality of the commodity; and increase the distance between demanders and suppliers. However, a limitation of the number of bankers and stock dealers could escape such mischief. Because the quantity of their dealings depended only on the aggregate supply of money – metallic money and convertible bank notes – it would not be decreased by a limitation of their number. The price and quality of their service would not be seriously influenced, because these depended on the rate of interest, and because the rate of interest would be regulated mainly by the aggregate supply of money. Finally, because most monetary dealings were done in the City, and because the number of banking houses would not be reduced, customers would not be inconvenienced by the limitation of the number of individual bankers and stock dealers (Bentham 1952–4 [no date], vol. 1: 373).

A tax on bankers' and stock dealers' profits had another advantage compared with a tax on profits in other branches of business. The assessment of their profits would be easier and less vexatious. If bankers and stock dealers accepted the new tax on profits with monopoly rights, they would suffer a loss at first. However, since the quantity of dealing would continuously increase because of high economic growth in England, the benefit derived from the exclusive privilege would make up and exceed the loss at a certain point of time in the future. Thus, the tax on bankers' and stock dealers' profits with compensation in the form of a limitation of their number would harm no one.

It must be stressed that, in *Proposal for a Mode of Taxation* – written prior to the suspension of the specie convertibility of Bank of England notes in 1797 – the tax on bankers was not proposed as a means to restrict the issue of bank notes.[11] Bentham proposed this tax only as a financial measure to ensure supply without burden. In contrast, in *Paper Mischief* and *The True Alarm* – both of which were written after the suspension of conversion – Bentham put forward the tax on bankers in order to restrict the quantity of bank notes.

4.2.4 Bentham's preference order of taxes

Bentham had a plan to complete a list of taxes with a view to their order of preference, including an extension of the escheat law and taxes on the profits of bankers and stock dealers. In *General View of a Complete Code of Laws*, Bentham stated:

> a treatise upon finance ought to begin with two tables: – [1.] A table of all the inconveniences which can possibly result from every kind of tax; 2. A table of all the taxes, arranged in the most convenient order for facilitating the comparison and showing the particular qualities of each one.
>
> (Bentham 1962 [1820], vol. 3: 204)

Traces of this work are seen in *Analytical View or Summary Sketch of Financial Resources, Employed and Employable* (Bentham 1952–4 [1794a], vol. 1: 277–8) and in manuscripts collected in the Dumont papers, box LXXII (Stark 1952–4, vol. 3: 540–5). On the basis of this evidence and Bentham's fragmentary statements on various taxes, we can reconstruct the preference order.

The best method of finance was the law of escheat. In fact, in *Supply without Burden*, Bentham stated that '[t]he object of the present Essay is, to point out that mode of supply which, for one of so great a magnitude, will, I flatter myself, appear to be absolutely the *best*' (Bentham 1952–4 [1795], vol. 1: 283; emphasis in original).

In general, indirect taxes were less painful than direct taxes, because '[t]o an *indirect* tax, each man pays no more than he pleases; and the vexation attendant on the collection of it is confined to the makers and vendors of the commodity taxed', whereas '[t]o a *direct* tax, each man pays what the imposer of the tax pleases, and the vexation embraces every man who pays [it]' (Bentham 1952–4 [1801–4], vol. 3: 366–7; emphasis in original). People could avoid consumption taxes – if they wished – by refraining from consumption of the commodity taxed. However, this held true only with respect to taxes on luxuries. People – in particular, the poor – could not escape taxes on necessities. To Bentham, taxes on necessities were oppressive taxes to be abolished (Bentham 1952–4 [1793–5], vol. 1: 245 and 1962 [1793], vol. 2: 580).

Bentham divided direct taxes on income into two categories: taxes on income with compensation; and those without compensation. Bentham preferred taxes on income with compensation to consumption taxes:

> Between [the] three classes of contributions, [viz.] taxes on branches of industry susceptible of an adequate indemnity on the one hand, and taxes on consumption and taxes on branches of industry not susceptible of an adequate indemnity [on the other], the order of preference seems now established, and that as tolerably solid as well as conspicuous: the first demands the preference over both the other two.
>
> (Bentham 1952–4 [1794b], vol. 1: 401)

Thus, the second best form of taxation was taxes on income with compensation: for example, a tax on bankers' and stock dealers' profits offset by an exclusive privilege; and the third best was taxes on luxuries. Taxes on incomes ineligible for compensation came fourth in Bentham's order of preference.

Bentham regarded the land tax as a special income tax levied on land tenure. Bentham wrote: 'I do not look upon the Land Tax in any shape or in any proportion as a just and eligible tax' (Stark 1952–4, vol. 3: 529). The inequality that landed property alone was taxed could be corrected by imposing the same kind of tax on non-landed properties and non-property incomes; an income tax with or without compensation was Bentham's answer. Hence, to Bentham, an income tax meant an extension of the land tax (Stark 1952–4, vol. 3: 543). If this was true, the landed class should be exempted from the income tax as long as they paid the land tax, or the land tax should be abolished if the landed class paid an income tax.

The worst tax, which Bentham repeatedly condemned, was a tax imposed on law proceedings. In the essay entitled *A Protest Against Law-Taxes*, Bentham concluded:

> that a law tax is the worst of all taxes, actual or possible: – that for the most part it is a denial of justice, that at the best, it is a tax upon distress: – that it lays the burthen, not where there is most, but where there is least, benefit: – that it co-operates with every injury, and with every crime: – that the persons on whom it bears hardest, are those on whom a burthen of any kind lies heaviest, and that they compose the great majority of the people.
>
> (Bentham 1962 [1793], vol. 2: 582)

For similar reasons, taxes on medicines, on insurance against calamities, on contracts (in particular, on borrowing money), and on the means of political information (for example, newspapers) would follow the law tax as bad taxes to be abolished (Bentham 1952–4 [1801–4], vol. 3: 369 and 1962 [1830], vol. 9: 451). These taxes, as well as taxes on necessities, would not only infringe the social interest but also impose on the poor more heavily than on the rich.

The poll tax was not desirable as long as it could be imposed where the ability to pay was wanting (Stark 1952–4, vol. 3: 524). Bentham also thought that the existing system of poor rates had significant problems, although he believed that pauper management was necessary.[12] Finally, Bentham regarded both duties on imports and drawbacks on exports as *non-agenda*: the government should not encourage home industries through these measures.[13]

The reconstructed list of the order of preference – although it is still incomplete – demonstrates that Bentham had a consistent tax reform programme. In particular, the three most preferable options – the law of escheat, an income tax with compensation, and taxes on luxuries – constitute Bentham's view of a fair and efficient system of taxation. These measures would be consistent with the security-providing principle. Bentham also aimed to correct existing inequalities imposed by the tax burden – in particular, the burden of the land tax. However, Bentham did not pursue equality in taxation, because he thought it impossible to realize complete equality among different individuals. In *Anarchical Fallacies*, Bentham argued:

> In the valuation of men's faculties, is it meant that their possessions only, or that their respective wants and exigencies, as well as their ways and means, should be taken into account? In the latter case, what endless labour! in the former case, what injustice!
>
> (Bentham 1962 [1795–6a], vol. 2: 518)

Because of this, Bentham confined himself to proposing financial measures which would supply revenue without burden. It must also be noted that although Bentham always wanted to minimize the burden of taxes on the poor, his proposals and programmes did not directly aim at the redistribution of income nor the diffusion of property.[14] Equality was not given priority over security. The tax reform programme which aimed at equality in the burden of taxation was taken up by J. S. Mill (see Sections 8.3 and 8.4, pages 176–93).

4.3 Revenue by 'money-traffic'

4.3.1 The preliminary ideas

An extension of the escheat law and a tax on profits offset by compensation were proposals of taxation, although they aimed to minimize the burden on the people. The government could raise revenue, with less burden, by intervening in 'money-traffic', namely 'the exchange of money in one shape, for money in another' (Bentham 1952–4 [1794–5], vol. 2: 120). In the period 1794–6, Bentham put forward two measures to raise revenue from 'money-traffic': buying and selling of the life annuities by government and issuing and circulating Exchequer Notes as new paper money.

Government dealings in life annuities were discussed in *A Plan for Augmentation of the Revenue*. Bentham argued that '[f]or life annuities payable for the life of the purchaser there would be no want of demand: the great want is that of supply' (Bentham 1952–4 [1794–5], vol. 2: 131). The government would be able to sell the life annuities on more advantageous terms than any private supplier, because the security of government was perfect. The government could buy life annuities at a price lower than their real value, because no perfect market in life annuities was established. Thus, the government could profit from buying and selling life annuities. The profits would be used to reduce the outstanding public debt. Bentham's proposal for life annuities could be regarded as a measure to lighten the burden of the public debt by transferring it into life annuities. Although Bentham acknowledged that '[g]overnment in general is unfit for the exercise of a lucrative occupation in comparison of individuals' (Bentham 1952–4 [1794–5], vol. 2: 146), dealings in life annuities were an exception. The government could be the most trustworthy and long-lived dealer of life annuities.

The Exchequer Notes scheme was put forward in *Proposal for the Circulation of a [New] Species of Paper Money*.[15] Bentham argued that the government suffered an invisible loss because it did not have a circulating paper:

> Bank notes, though bearing no interest, circulate at par. Even private notes, the notes of country bankers, do the same. Government paper not without interest, and that, even when carrying interest at upwards of 4½ per Cent, scarce bearing a premium.
>
> (Bentham 1952–4 [1795–6b], vol. 2: 155)

The circulating medium in the United Kingdom at the end of the eighteenth century consisted of gold coin, Bank of England notes and country bank notes: bills of exchange and bank deposits were also used in wholesale transactions. In England, the Bank of England was the only chartered bank. As a joint stock bank, it issued notes on the basis of bullion. English country banks – namely non-London private banks – also issued bank notes: they held their reserves mainly in deposits with London private banks (non-issuing banks), whose main reserves in turn consisted of Bank of England notes. Ireland and Scotland had their own banking systems. In Scotland, non-chartered joint stock banks, as well as private banks, were permitted to issue notes: their reserves consisted of notes and deposits of the Scottish chartered banks, who themselves held deposits at the Bank of England. No central banking system had yet been established for the United Kingdom, although any difficulties finally fell on the Bank of England (Fetter 1965: 33–7). Bentham believed that, in contrast to the Revolutionary period, the British government now held sufficient power and credit to issue and circulate its own paper money in the place of bank notes. Bentham proposed a form of governmental money called 'Exchequer Notes'.

Exchequer Notes would initially be offered at interest of 2 per cent in order to attract people and replace existing bank notes. Interest would be paid annually in cash, and the principal could also be paid back by cash on demand. In order to prevent a run, the government would reserve the option of paying back 'an Exchequer Annuity Bond', which would grant a perpetual redeemable annuity. In order to ensure the acceptance of this option, the rate of interest on this bond would be higher than that on public debt (Bentham 1952–4 [1795–6b], vol. 2: 181).

When Exchequer Notes were completely accepted as a means of circulation, the rate of interest would be reduced gradually. The value of the

Exchequer Notes to be issued would be the same as that of the existing bank notes. Bentham estimated it at about 40 million pounds:

> the profit to government by the monopoly of the paper currency will be the difference between the interest they pay upon these 40 millions, and the amount of the annuities they would have had to grant for the same capital, had it been obtained upon the ordinary terms. If it ends, as there seems reason to expect it should, in the circulation of such Notes even without interest, the profit will then be the borrowing [of] 40 millions without interest, or, to speak more correctly, the obtaining *gratis* 40 million of the money they employed.
>
> (Bentham 1952–4 [1795–6b], vol. 2: 196; emphasis in original)

Thus, Bentham believed that the government could make a profit equal to the value of the Exchequer Notes to be issued. Although the issue banks would suffer a loss by this scheme, Bentham did not offer compensation for the loss. If Exchequer Notes did not completely replace the bank notes, and if national wealth was uninfluenced by this scheme, the price level would rise, because the total amount of paper money would increase. However, in this plan, Bentham did not explain the macroeconomic effects of the scheme in detail. Despite such incompleteness, the scheme of Exchequer Notes – as well as the plan of buying and selling of the life annuities – was the preliminary to a full-scale scheme for money trafficking, namely the Annuity Notes scheme.

4.3.2 The scheme of Annuity Notes

In 1797, when rumours of a French invasion provoked a run on the banking system, the British government suspended specie convertibility of Bank of England notes. Although this suspension was supposed to be temporary, it continued until 1821. Now Bank of England notes circulated only on the basis of its historical credit. In this monetary circumstance, Bentham reconsidered the ideas of life annuities and Exchequer Notes. In *Abstract or Compressed View of a Tract Intituled Circulating Annuities*, Bentham synthesized these ideas, and put forward the scheme of Annuity Notes as a means of extinguishing the redeemable public debt. Bentham proposed this scheme to Nicholas Vansittart, then Secretary to the Treasury.

Bentham's scheme can be explained as follows (Bentham 1952–4 [1800], vol. 2: 208–24). The government would issue paper money called 'Annuity Notes', which would grant the possessor a perpetual redeemable annuity, although the principal was not payable on demand. The annual rate of interest of Annuity Notes would start at 3 per cent – lower than the market rate of interest on the public debt at 3 per cent interest. The interest could be paid on demand biannually, for example at the post office.

The value of the Standard Annuity Note was £12 16s., and notes of smaller and larger denominations would be issued as the need arose: Bentham considered nineteen kinds of notes in total. The value of an Annuity Note increased daily at compound interest consistent with the annual rate of 3 per cent. On the face or back of each Note, a table of the daily value for a year and tables of the yearly and half-yearly values for 34 years would be printed. The date when the interest was last paid at the office would be recorded on the Note: thus, people could calculate the present value of the Note by using the tables and the record of the last payment. Because Annuity Notes were used as a circulating medium, the holders could receive the interest not only by going to the office every half year, but also by selling them to others in exchange for commodities, metallic money, or bank notes.

Annuity Notes at 3 per cent interest would be sold to money holders who would demand them not only as an asset which would produce interest, but also as an alternative means of circulation: Bentham believed that there was no want of demand for the Notes.[16] The sales of Annuity Notes would be used to buy in the public debt. Because the average market price of the public debt at 3 per cent was below par, the government could make a surplus by selling an Annuity Note and buying an amount of the public debt of equal face value. Because the market prices of public debts at 4 per cent and 5 per cent interest were also below the face value of public debt at 3 per cent interest, the government could make a profit from buying all kinds of public debts. This surplus would be transferred to the sinking fund, and used to buy more public debt. The purchase of public debt by the government would increase its market price: consequently, the market rate of interest on public debt would fall. When the price of public debt reached its face value, the government could stop buying and start to pay it off – to oblige the stockholders to sell their public debts to the government at par. Consequently, the government could extinguish all redeemable debts, without a loss, by continuing to issue and sell Annuity Notes at 3 per cent interest.

When all redeemable public debts were paid off, the government would issue Annuity Notes at a lower rate of interest, for example, 2.5 per cent: this would be carried out by raising the face value of every Note. This lower rate of interest would be accepted, because the market rates of interest – including those of unredeemable public debt and Exchequer Bills – would have been lowered by the extinction of redeemable public debt: unlimited demand for Annuity Notes would also make the lower rate of interest acceptable. Annuity Notes at 3 per cent interest would be circulated with a premium for a while. However, the government would pay off the old Notes by the sale of the new Notes. The holders of Annuity Notes at 3 per cent interest would have to sell them at face value which would have increased at the rate of compound interest since the last interest payment. Because of this conversion, the interest on Annuity Notes which the government had to pay would be reduced. The surplus produced by the reduction of the interest rate would be used to collect the old Notes.

When all Annuity Notes at 3 per cent interest were paid off, Annuity Notes at a lower rate of interest – for example, 2 per cent – would be issued, and Notes at 2.5 per cent interest would be replaced with them. By repeating the same process, the government could reduce the interest on Annuity Notes as far as possible. Annuity Notes at the lowest rate – for example 1 per cent – would be demanded mainly as a secure means of circulation, rather than an interest-bearing asset. There would not be many holders of the Annuity Notes who would visit the office to receive their interest. The annual amount which the government would pay in the interest on the Annuity Notes would be negligible. The government did not have to pay off Annuity Notes at 1 per cent interest by taxes: such a redemption would impose a burden on the people and take a means of circulation from them.

Thus, the financial problem with respect to the payment of public debt would be resolved. Bentham thought that the Annuity Notes scheme would shorten the redemption period of the existing public debt from 37 years to 30 years (Stark 1952–4, vol. 3: 463). Whenever new public debt was issued – for example, because of a war – the same measure could be applied to pay it off.

The Annuity Notes scheme was an extension of the idea of Exchequer Notes. In fact, the Annuity Notes scheme provided for the redemption of public debt by issuing new paper money. However, in contrast to the Exchequer Notes, the principal of Annuity Notes would not be redeemable on demand: thus they could avoid a run. Moreover, Bentham did not intend to replace all bank notes with Annuity Notes: the total amount of the Annuity Notes would be determined by the amount of outstanding public debt – not the value of existing bank notes. The scheme could also be regarded as an extension of the life-annuities plan: the government would make a profit by buying and selling Annuity Notes, because the people's demand for secure annuities would be sufficiently large. However, in contrast to the life-annuities plan, the scheme aimed at reducing the amount of annuities which the government had to pay: in this sense the scheme was a plan to pay off debts through refunding them at a lower rate of interest. The Annuity Notes scheme illustrated Bentham's idea of debt management: debts could be managed by issuing paper money and by refunding them at a lower rate of interest.

Bentham recognized that his Annuity Notes scheme was adapted from the *Assignats* used in France 1789–97 (Bentham 1952–4 [1800], vol. 2: 206 and 225). *Assignats* were paper money bearing 5 per cent interest, with the nationalized church lands as security. However, they failed to circulate because people distrusted the worth of the security. Bentham wrote:

> *This* currency came, in no short space of time, to an end. True: but from what cause? – not from the *embarrassment* attending to the *com-*

> *putations* (this is pretty well established by the examples given already) but from the worthlessness – the absolute worthlessness of the *security*.
>
> (Stark 1952–4, vol. 2: 389; emphasis in original)

Bentham believed that, because Annuity Notes would not rely on any security, and the amount issued was limited by the existing public debt, they would escape the failure of the *Assignats*.

4.3.3 Advantages and disadvantages of the scheme

In the conclusion of his Annuity Notes scheme, Bentham listed four major advantages of the scheme: (1) financial profit; (2) promotion of frugality; (3) constitutional stability; (4) growth of national wealth (Bentham 1952–4 [1800], vol. 2: 298). The only disadvantage was that the scheme could be accompanied by a general rise in prices, or inflation.

Bentham argued the Annuity Notes scheme would not only produce financial profits but also promote frugality in the people (Bentham 1952–4 [1800], vol. 2: 293–5). In contrast to public debt and Exchequer Bills, Annuity Notes included small-denomination Notes, which all classes of society – in particular the poor – could buy and hold for the purpose of receiving interest. Although the rate of interest on Annuity Notes would be gradually reduced – and consequently, the incentive to frugality would be weakened – the condition of the poor would be improved in the meantime, and the habit of frugality would take root among them. Thus, the Annuity Notes scheme would be consistent with the equality-maximizing principle.

By taking the mass of the people into the circle of the moneyed interest, Annuity Notes would contribute to constitutional security. Bentham argued:

> Among the effects resulting from the national debt, in the *early* stages of its existence, was the security it afforded to the old established constitution, by engaging the *purses* and *affections* of the moneyed *interest* in the service and support of the new-established government. *That* was the *great* moneyed interest. . . . The advantage resulting from the transmutation of that debt into the proposed form would be – the securing to the constitution and government now grown into one, the support of what may be called the *little moneyed* interest by the same powerful tie.
>
> (Bentham 1952–4 [1800], vol. 2: 296; emphasis in original)

According to Bentham, since the Revolution of 1688, Britain had avoided tyranny and maintained the constitutional order because every sovereign had relied on the money raised by the public debt: this money had been supplied by 'the great moneyed interest', namely the rich public creditors. The present constitutional problem in Britain was not monarchical tyranny, but popular anarchy. Consequently, if the popular pecuniary interest was consistent with the continuation of the present government, constitutional stability would be maintained. The Annuity Notes scheme would accomplish such an object by making the masses 'the little moneyed interest'. Because Annuity Notes would extinguish the public debt, the little moneyed interest would take over the role of a financial supporter of the government from the great moneyed interest. Thus, as Bentham concluded, '[*s*]*tock*, in its large doses, served for the disorder of *that* time: *paper*, in its small doses, is the specific for the *present*' (Bentham 1952–4 [1800], vol. 2: 296; emphasis in original).[17]

Bentham believed that the Annuity Notes scheme would increase national wealth, as was the case with the redemption of public debt by the sinking fund.[18] The sinking fund was financed by taxes, and taxes were paid by a reduction of consumption. Because the redeemed money would be invested by the public creditors in productive capital, the redemption of public debt by the sinking fund would transfer taxpayers' consumption to public creditors' savings. Similarly, Annuity Notes would be bought by the money holders: they would buy the Notes by reducing their consumption. Public debt would be bought or paid off by the sales amount of the Annuity Notes. The money repaid to the public creditors would be invested in productive capital. Consequently, the redemption of public debt by Annuity Notes would increase the national capital by transferring the money holders' consumption into the public creditors' savings. When the public debt was issued, the public creditors' savings would be transferred into the government's unproductive expenditure. Hence, the net increase in national capital would be the difference between the amount the government had received from the public creditors and the amount the government would repay them: usually the amount repaid would be larger than the amount received, because the public debt was undertaken by public creditors below par when it was issued. Thus, redemption of public debt by Annuity Notes, as well as by the sinking fund, would increase the net national capital, and consequently the net national wealth (Bentham 1952–4 [1800], vol. 2: 266).

However, in contrast to the case of the sinking fund, the redemption of public debt by Annuity Notes could raise the price of commodities. Given the constant quantity of commodities, prices would not rise if all Annuity Notes were hoarded by the holders. By contrast, if Annuity Notes were used as a means of circulation, prices would rise, at least until the increase in national wealth caught up with the increase in the circulating medium. The Annuity Notes scheme would have the same effect as an increase in paper money, unless all Notes were hoarded – whereas the scheme would have the same effect as a redemption of public debt by the sinking fund, if all Annuity Notes were hoarded.

Bentham thought that inflation was undesirable. It was an indirect tax on incomes, the nominal amount of which was fixed; the rent of land on a long-lease, interest on money lent, all kinds of annuities, salaries, and so on. In fact, inflation would transfer the real purchasing power from fixed incomes to incomes which increased in proportion to the increase in prices. Whereas the gain from compensation would be scarcely perceived, the loss by a rise in prices would be acutely felt. Bentham argued that 'the enjoyment produced by gain is never equal to the suffering produced by loss: if it were, the main reason for affording protection to property would cease' (Bentham 1952–4 [1800], vol. 2: 286). Inflation impeded the security-providing principle – the most important principle for the end of achieving greatest happiness.

The increase in national wealth because of the addition to productive capital could catch up with the entry of Annuity Notes into circulation. In this case, inflation would stop in the long run. However, this would not always be the case. Inflation would lower the real purchasing power of money repaid to the public creditors. Consequently, their contribution to productive capital would diminish. If Annuity Notes were spent on consumption, the proportion between consumption and investment might not change. If this was true, no real addition would be made to productive capital, and consequently the national wealth would not increase. Thus, inflation would hinder the wealth-creating effect of the Annuity Notes scheme.

Moreover, even if national wealth increased, the increase would cease when all redeemable public debt was paid off. Meanwhile, Annuity Notes would remain in circulation and increase their value infinitely at compound interest: although the interest rate of the remaining Annuity Notes would be lower than those initially issued, a larger proportion of Annuity Notes would circulate. Consequently, the increase in national wealth by the redemption of public debt could not stop the inflationary pressure.[19]

Bentham emphasized that Annuity Notes had two alternative functions: interest-bearing assets and means of circulation, arguing that 'it seems impossible to say in what proportions, at any given time, the quantity of Annuity Note paper, remaining at that time, will find itself distributed between the two classes' (Bentham 1952–4 [1800], vol. 2: 283). According to Bentham, Annuity Notes would be hoarded as an asset when there was an excess supply of money – namely, in periods of inflation – and they would be drawn into circulation when there was a lack of money – in periods of deflation. In other words, '[an Annuity Note] would be *stock* one moment and *cash* the next, whichever were most wanted' (Bentham 1952–4 [1800], vol. 2: 274; emphasis in original). However, Bentham did not demonstrate the mechanism of this self-adjustment. Bentham did not explain why an individual holder of Annuity Notes would hoard (draw) their Notes in periods of inflation (deflation). In fact, the holders of Annuity Notes may act in the opposite way. That Annuity Notes had two alternative functions was not enough to support the claim that the scheme was free from inflationary dangers.

Bentham suggested that inflation could be restricted by stopping the issue of small-denomination Notes: this would increase the proportion of Annuity Notes hoarded (Bentham 1952–4 [1800], vol. 2: 284). However, this measure would also diminish the proportion of Annuity Notes hoarded by the poor, because they could not afford to hold large-denomination Notes. The social and constitutional advantage of Annuity Notes – namely, the creation of a little moneyed interest – would be hindered by limiting Annuity Notes to large-denomination Notes.

In order to increase the proportion of Annuity Notes hoarded, a higher rate of interest would be more desirable: a higher rate of interest would also promote popular frugality. However, from the viewpoint of financial profit, the rate of interest on Annuity Notes had to be reduced to as low a level as possible.

Thus, inflation – the only disadvantage of the Annuity Notes scheme – could not be prevented by the first advantage of Annuity Notes, namely by the growth in national wealth produced by the redemption of public debt: in contrast, inflation would hinder such a growth of national wealth. Inflation could not be restricted without infringing on the other three advantages: financial profit; promotion of frugality; and constitutional stability. Were there any measures to prevent inflation without removing the four advantages of Annuity Notes?

If bank notes were crowded out of circulation in proportion to Annuity Notes flowing into circulation, inflation could be avoided. Bentham believed that this would naturally occur. If bank notes were not naturally excluded, the government could artificially reduce them by refusing to receive at its own offices anything other than Annuity Notes. More effectively, the government could impose a tax on the issue of bank notes. Bentham proposed that the tax would be imposed first on the country banks, and – if sufficient bank notes were not removed – on the Bank of England second (Bentham 1952–4 [1800], vol. 2: 284–5). Although bankers would suffer a loss, their loss would be much smaller than the loss which the people – particularly people of fixed income – would have suffered from inflation. Thus, a tax on bankers was Bentham's final answer to the problem of inflation.

However, a tax on bankers contradicted Bentham's own claim that, in contrast to the redemption of public debt by the sinking fund, the Annuity Notes scheme did not have to rely on taxation. In fact, the scheme required a special tax on bankers in order to prevent inflation.

4.3.4 The abandonment of the scheme

Bentham sent his scheme of Annuity Notes to Vansittart. However, Vansittart did not regard Bentham's scheme as practical. In particular, it would be difficult to calculate the worth of small-denomination Notes because of their daily changing value. Bentham also received an opinion on his scheme from Frederic Morton Eden, one of his friends, who Vansittart commissioned to examine Bentham's scheme. Eden's opinion was also unfavourable. Eden did not believe that there would be sufficient demand for Annuity Notes, whose interest was lower than public debt and Exchequer Bills. Bentham argued that there would be sufficient demand because Annuity Notes would be a means of circulation as well as an interest-bearing asset. However, Eden thought that Annuity Notes were unsuitable for a circulating medium. Annuity Notes wanted the most important feature of a circulating medium – quick and simple computations. Because an Annuity Note changed its value daily, people would have difficulty in calculating it even with a table printed on the back of the Note. Moreover, this difficulty would increase by the fact that the same denomination Notes would have different values depending on when interest on the Note was last paid. Thus, the fact that Annuity Notes had two functions made it difficult for them to be in wide demand.

Although Bentham wrote a letter to Eden in order to defend his Annuity Notes scheme, he never argued for the scheme in his later writings. However, the reason Bentham gave up the scheme was its macroeconomic disadvantage, namely inflation, rather than its administrative impracticability. In *Paper Mischief [Exposed]*, Bentham explained the reason for his abandonment of the scheme:

> I was actually occupying myself with contrivances for adding to the existing mass of the circulating medium. When, as the enquiry advanced, I came to examine into the supposed connection [between paper money and wealth], and taking measure of evil [of inflation], great was my surprize to find the connection purely imaginary, and the evil swelling to a most enormous magnitude, swelling to such a magnitude as to eclipse those which, among evils of the same kind, have hitherto been felt as inflicting the severest pressure.
>
> (Bentham 1952–4 [1800–1], vol. 2: 429)

It was William Anderson's pamphlet, *The Iniquity of Banking: or, bank notes proved to be injurious to the public, and the real cause of the present exorbitant price of provisions* (1797), that enlightened Bentham as to the defect in his scheme.[20] If Annuity Notes would be guilty of inflation, so were bank notes. In fact, the value of money was half what it had been 40 years before because of the almost unlimited issue of bank notes. Worse, bank notes – if issued beyond the value of the banker's assets – would produce a credit crisis: bankers would be bankrupted, and commercial security would be completely destroyed. For these reasons, Bentham claimed that bank notes – in particular those of country banks – should be restricted, supporting Anderson's plan for the introduction of new governmental currency. However, Bentham did not accept Anderson's proposal for the prohibition of all bank notes by law. Bentham thought that such a prohibition would produce a general bankruptcy of bankers (Bentham 1952–4 [1800–1], vol. 2: 430–3).

Bentham discussed his plan for the restriction of bank notes in more detail in *The True Alarm*. Most of this pamphlet was written in the four months after Bentham finally gave up the Annuity Notes Scheme at the end of August 1801 (Stark 1952–4, vol. 3: 10). In *The True Alarm*, Bentham still believed that an increase in paper money would increase national wealth by increasing the proportion of savings in the country, as well as by absorbing unemployed labour (Bentham 1952–4 [1801a], vol. 3: 67 and 109). However, Bentham acknowledged that 'this addition to real wealth, made as it is at the expence of fixed rents and with a continual danger of bankruptcy, is an advantage too dearly bought' (Bentham 1952–4 [1801a], vol. 3: 149).

The True Alarm criticized Walter Boyd's *A Letter to the Right Honourable William Pitt, on the Influence of the Stoppage of Issues in Specie at the Bank of England, on the Prices of Provisions, and other Commodities* (1801). Boyd ascribed the recent inflation to the suspension of conversion and the over-issue of Bank of England notes – rather than to the over-issue of country bank notes. Boyd claimed that a resumption of conversion in Bank of England notes would solve the problem (Stark 1952–4, vol. 3: 7–13). Bentham rejected this opinion. Inflation could be controlled without relying on bullion. Moreover, a resumption of conversion would produce a run on the banks, and consequently bankruptcy for the bankers. Thus, Bentham dismissed Boyd's claim for the resumption of conversion, as well as Anderson's plan for the prohibition of all bank notes by law.

Bentham's own scheme was composed of two Acts for registration of banking houses and taxation of paper issues (Bentham 1952–4 [1801a], vol. 3: 175–6). Through these measures, bank notes would be restricted without producing bankruptcy for the bankers. This scheme could be seen as a revival of the plan for a tax on bankers' profits but with compensation. A banker's profits from the issue of notes would be taxed, and the loss due to the tax would be compensated by a limitation of their number through a licence system. However, in contrast to the 1794 pamphlet, the proposal in *The True Alarm* aimed at restricting the quantity of bank notes – not raising revenue.[21]

Because Bentham gave up the idea of paying off public debt by Annuity Notes, the only means of redemption left to him was the sinking fund – namely, taxation. Bentham did not abandon his claim that a redemption of public debt by taxation increased national wealth. In *Institute of Political Economy*, Bentham argued:

> The amount of taxes imposed in discharge of debt of itself neither adds to, nor takes from, the mass of national wealth. . . . But when, and

> in so far as, the money produced by these taxes is actually employed in discharge of debt, it adds to capital, and thereby to growing wealth.
> (Bentham 1952–4 [1801–4], vol. 3: 321)

The redemption of public debt by taxation would produce the same effect as forced frugality – taxation for the purpose of increasing capital – which was regarded as *non-agenda* for the government. However, Bentham accepted this type of forced frugality (Bentham 1952–4 [1801–4], vol. 3: 343–4). Bentham also acknowledged that the reduction of public debt would lower the rate of interest.[22]

In *Institute of Political Economy*, Bentham still maintained that an increase in paper money would increase national wealth. This could happen because the increase in paper money would be most probably lent to people who would add it to productive capital. However, in contrast to the redemption of public debt by taxes, this type of forced frugality – 'forced savings' in modern terminology – was unacceptable, because it would produce inflation and bankruptcy (Bentham 1952–4 [1801–4], vol. 3: 344–5). Thus, Bentham accepted a conclusion that public debt had to be paid off by taxation – not by issuing paper money. Although it would take longer to redeem all public debts only by taxation, this disadvantage was negligible compared with the disadvantages of inflation and a credit crisis. By 1804, Bentham's main concern in political economy shifted from public finance to monetary regulation.

4.4 Conclusion

Bentham believed that government expenditure should be managed in order to limit its purpose to security. Bentham also argued that the pain and evils associated with taxation should be minimized, and that the main purpose of taxation had to be to raise revenue.

On the basis of these principles, Bentham attempted to establish a fair and efficient system of taxation, which would be composed of: (1) an escheat law; (2) an income tax with compensation; and (3) taxes on luxuries. In fact, Bentham proposed an extension of the existing law of escheat, and a tax on bankers' and stock dealers' profits with an exclusive privilege. In these proposals, Bentham always intended that his proposals could promote equality – or at least prevent gross inequality. However, Bentham's main concern was to raise revenue for the Revolutionary and Napoleonic Wars without impeding the security-providing principle.

Bentham's ideas on debt management are revealed by his Annuity Notes scheme, which resulted from two preliminary measures to raise revenue through 'money-trafficking'. In fact, the scheme proposed a redemption of public debt by issuing paper money and by refunding the debt at a lower rate of interest. Bentham believed that Annuity Notes – a kind of interest-bearing asset – would promote frugality of the poor, constitutional stability, and national wealth. Thus, the scheme seemed to satisfy the equality-maximizing and security-providing principles. However, this scheme had a fatal disadvantage, namely inflation. Inflation would prevent national wealth from growing, as well as reduce the real purchasing power of fixed income. People of fixed income would no longer consider the security of their property protected by the government. Thus, the Annuity Notes scheme violated the security-providing principle. For this reason, Bentham abandoned the scheme.

If Annuity Notes would be guilty of inflationary tendencies, so were bank notes. An excess of bank notes had another disadvantage – the danger of bankruptcy to bankers. Bankruptcy of the bankers would produce a credit crisis, which would destroy the security of commerce and property in the country. In order to prevent such a disaster, Bentham proposed a tax on the issue of bank notes, as well as registration of banking houses. In fact, this proposal was a tax on bankers' profit with the compensation of an exclusive privilege. However, the main purpose of the tax was to restrict the quantity of bank notes, not to raise revenue. A tax for such a purpose might have contradicted Bentham's claim that the main purpose of taxation had to be revenue. However, to restrict the quantity of bank notes by the tax on bankers was consistent with the security-providing principle, and consequently included in the *agenda* of the government.

Bentham's schemes of public finance, as well as those of monetary regulation, were consistent with his fundamental view of the principles of legislation with respect to political economy: the security-providing principle should always be given first priority, and then the equality-maximizing principle could be pursued. Bentham's 'principles of legislation in matters of finance' would have followed 'the principles of legislation in matters of political economy', if he had completed his system of legislation.

Notes

1 Bentham also indicated that the tenth (final) part would treat of method and terminology in every branch. With respect to the plan Bentham stated: '[These] are the titles of the works by the publication of which his [the author's] present designs would be completed. They are exhibited in the order which seemed to him best fitted for apprehension, and in which they would stand disposed, were the whole assemblage ready come out at once; but the order, in which they will eventually appear, may probably enough be influenced in some degree by collateral and temporary considerations' (Bentham 1970 [1789]: 5–6). For Bentham's views on political economy as a branch of legislative science, as well as his distinction between 'science' and 'art' of political economy, see Lieberman (2000: 107–8).

2 Kelly (1989: 71–4, 1990a: 252, and 1990b: 93) emphasizes that Bentham regarded expectations as a major source of utility.

3 Historians of economic thought differ over Bentham's relation to 'classical' economists. For example, whereas Stark states that 'Bentham did not simply accept Smith's economic doctrines, but developed them to their logical conclusion' (Stark 1941: 58) and that 'there is undoubtedly a strong streak of the Ben-

thamite spirit in Ricardo's thought, and in all classical economists' (Stark 1946: 583), Hutchison (1956: 306) argues that 'if Bentham is still to be described as a "classical" economist, along with Smith and Ricardo, then this much-controverted adjective is virtually emptied of any doctrinal significance'. Black (1988: 27) indicates that '[i]t is these two Benthams [i.e. Bentham the philosopher and Bentham the social reformer], much more than the third, Bentham the economist, whose influence pervaded both classical and neoclassical economics'. This book will show that, with respect to public finance, Bentham was an original thinker – with ideas distinct from those of Smith and Ricardo – and that his tax reform proposals influenced J. S. Mill.

4 The term 'escheat' in feudal law referred to the custom that land reverted to the king if the owner died intestate and without heirs.

5 Bentham's works on public finance are discussed in Stark's 'Introduction' to *Jeremy Bentham's Economic Writings* (Stark 1952–4, vol. 1: 58–78 and vol. 2: 7–113); they were briefly referred to also by Viner (1949: 370), Steintrager (1977: 75), Harrison (1983: 258), Bonnar (1995: 39–41), and Sigot (2001: 79–90). However, these works do not examine Bentham's public finance proposals in terms of the security-providing and equality-maximizing principles. Regarding the security-providing principle (or the disappointment-preventing principle) as the most important basis of Bentham's political economy and civil law, Kelly (1989: 80) argues that Bentham's works on public finance 'are best seen as attempts to maintain a stable pattern of expectations. . . . These works are based on an attempt to eradicate the need for direct taxation as a means of government supply, on the grounds that the increasing need to resort to taxation was undermining those expectations based on the disposal of property, and this ultimately reduced economic activity and social well-being'. This chapter reinforces Kelly's view by examining Bentham's overall plan of public finance and monetary regulation.

6 This section draws on Dome (1999).

7 A similar statement is seen in Bentham's manuscript collected in the Dumont papers, box LI (Stark 1952–4, vol. 3: 537).

8 Bentham stated: 'Had this resource happened to have presented itself under a favourable aspect to the Neckers or the Calonnes, and had they succeeded in recommending it to the acquiescence of the nation, the French Revolution, and the flood of miseries with which the earth has been deluged by it, would have been prevented' (Bentham 1952–4 [1795], vol. 1: 326).

9 However, Bentham argued that the law of primogeniture was behind the times and unnecessary for the support of the aristocracy (Bentham 1952–4 [1795], vol. 1: 330). For Bentham's conversion to political radicalism see, for example, Dinwiddy (1975).

10 Bentham later attached more importance to equality with respect to the purpose of the escheat law. For example, Bentham argued in 1821: 'In the case of each individual, a particular point of time there is at which, without defalcation made from security in his instance, or in the instance of any other individual, his property may be subjected to a distribution or other disposition whereby, according to the amount of it, equality will be promoted, advance towards absolute equality, made. This time is the time of a man's death' (Schofield and Harris 1998: 202).

11 Although Bentham argued that '[t]he general idea is, that within the limits of the Metropolis (those limits of course to be properly defined) no new banking house should be opened in future' (Bentham 1952–4 [1794b], vol. 1: 408), he did not mean to reduce the total amount of bank notes.

12 For example, Bentham stated: 'the compensation has been accompanied by the disadvantages and inequalities which it is so difficult to avoid in any system of

compensation. The workmen employed by the rich farmer have received a considerable part of their pay at the expence of the small farmer who does not employ labour, and at the expence of all other classes without distinction, from the richest men of property to the smallest artisans, in view of the fact that all are forced to contribute to the poor rate, unless they be themselves among the poor' (Bentham 1952–4 [1801a], vol. 3: 195). For Bentham's plan of pauper management, see Bentham (1962 [1798], vol. 8: 369–439).

13 However, Bentham suggested that a tax on exports could be a good financial method if they replaced burdensome domestic taxes: 'a tax upon *exports* to foreign countries is borne by the inhabitants of foreign countries. Whatever imposition of this kind foreigners can be made to bear, is so much gain to us. If, indeed, when a fresh tax is imposed upon an article of export, the quantity of it produced is considerably diminished by the tax, a temporary distress is thereby produced, the suffering of which may be less or greater than the suffering saved by the saving in the amount of taxes borne by ourselves. But if the quantity produced be merely prevented from encreasing, no such suffering is produced, and the benefit by the saving in home-paid taxes is pure' (Bentham 1952–4 [1801–4], vol. 3: 367–8; emphasis in original).

14 I agree with Steintrager's opinion that 'Bentham did not view the tax system as a means of redistributing the wealth of society' (Steintrager 1977: 74).

15 In *A Plan for Augmentation of the Revenue*, Bentham referred to this scheme as a measure to raise revenue from borrowing – one of money-trafficking. Bentham stated that 'the object [of Exchequer Notes] of course is to pay as little interest as one can' (Bentham 1952–4 [1794–5], vol. 2: 121).

16 Bentham (1952–4 [1800], vol. 2: 228) argued that Annuity Notes would be demanded on the basis of what we call 'transactions motive' and 'precautionary motive'.

17 With respect to the social and political aspects of the Annuity Notes scheme, Kelly (1989: 80) argues: 'The Annuity Notes plan involved a complex of different aims all directed at securing a stable social order. That Bentham should have chosen an interest-bearing species of currency as the best means of achieving these aims may appear bizarre, but it is arguable that this was the most important of his economic writings, at least in the sense that it brings together all the political aims of his economic thought'.

18 In the early drafts of the Annuity Notes scheme, Bentham argued that an increase in money would increase national wealth without raising money wages and prices if there was unemployed labour, and that an increase in money would raise money wages and prices without increasing national wealth if labour was fully employed. For example, see Stark (1952–4, vol. 2: 304, 311, and 328). However, this view was weakened as the draft was rewritten several times, and was eliminated in the final manuscript, in which it was argued that an increase in money would increase national wealth by transferring consumption to savings, rather than by absorbing unemployed labour. Thus, Bentham could demonstrate that Annuity Notes would increase national wealth, given full employment of labour.

19 Bentham did not recognize that this aspect of Annuity Notes – the automatic increase in the value – would promote inflation.

20 Bentham wrote: 'I had thus recognised my error and spread out before me the mass of argument that had led me to conviction, when, on seeing in an advertisement a pamphlet bearing for its title "The Iniquity of Banking", I was curious to observe the train of reflection that had been brought forward by another on the same side' (Bentham 1952–4 [1800–1], vol. 2: 429).

21 Bentham considered to impose a tax of 1.7 per cent in the pound, estimating that this would be a tax of 33 per cent on the profit made from the issue of bank notes (Bentham 1952–4 [1801a], vol. 3: 178).

22 In *Defence of a Maximum* (1801), Bentham argued that the fall of the interest rate would improve the terms of war loans. Thus, in contrast to *Defence of Usury* (1787), Bentham acknowledged the merit of a lower interest rate. Bentham stated: ‘At the times of writing the *Defence of Usury*, the effects of the restraining laws upon the terms of war loans had, I am free to confess, never presented themselves to my mind’ (Bentham 1952–4 [1801b], vol. 3: 289). However, Bentham did not change his opinion against the anti-usury laws: ‘The anti-usury regulations, being anterior to the birth of public credit, had not, at their origin at least, any such collateral effect in contemplation. . . . The only sources . . . were the passions and prejudices, the malignant passions and shallow prejudices, unmasked by the *Defence of Usury*’ (Bentham 1952–4 [1801b], vol. 3: 290).

5 Thomas Robert Malthus[1]

5.1 Introduction

When Thomas Robert Malthus published the first edition of his *Principles of Political Economy Considered with a View to their Practical Application* (1820; henceforth *Principles*), he did not devote any specific chapter, or even section, to the subjects of taxation and public debt, though he occasionally referred to these issues. Ricardo, who had already published *Principles of Political Economy, and Taxation* (1817), was disappointed to learn that Malthus's *Principles* would include no independent chapter concerning taxation. In November 1819, Ricardo wrote to Malthus as follows:

> I am glad to hear that your book will be so soon in the press, but I regret that the most important part of the conclusions from the principles which you endeavour to elucidate, will not be included in it, I mean taxation. . . . As soon as you have launched your present work, I hope you will immediately prepare to give us your thoughts on a subject in which are all practically interested.
>
> (Sraffa 1951–73, vol. 8: 130–1)

Malthus, who considered that the main object of the *Principles* was 'to prepare the general rules of political economy for practical application' (Malthus 1989 [1820], vol. 1: 21), attached importance to the issue of governmental intervention in the economy. Moreover, Malthus emphasized that taxation was one of those issues that political economy should deal with:

> As taxes cannot, in the nature of things, be imposed without interfering with individual industry and wealth, it becomes a matter of the very highest importance to know how they may take place with the least possible prejudice to the prosperity of the state, and the happiness of individuals.
>
> (Malthus 1989 [1820], vol. 1: 19)

Moreover, Malthus thought that taxation was the practical issue influenced most directly by the principles of political economy: 'the truth or falsehood of the theories on all the principal questions in political economy would occasion, or at least ought to occasion, a practical difference in the mode of raising some of the actual taxes' (Malthus 1989 [1820], vol. 1: 20).[2]

Soon after the publication of the first edition of the *Principles*, Malthus started to write manuscript alterations in margins and between lines in a copy of the first edition: this is now called the Manuscript Revision.[3] Interestingly, in the table of contents of the Manuscript Revision, two headings were inserted between Chapter 6 and Chapter 7: one was 'On the distribution of the precious metals and the causes of their relative value in different countries'; the other was 'On Taxation' (Malthus 1989 [1820], vol. 2: 251). According to John Pullen, Malthus also wrote a letter in October 1827 to John Murray, the editor of the first edition of the *Principles*, saying that he was thinking of its second edition which would include new matters on taxation and the level of precious metals (Malthus 1989 [1820], vol. 2: 431). These facts clearly show that Malthus planned to add a chapter on taxation for the second edition of the *Principles*.

However, in the second edition, published in 1836 (two years after Malthus's death), we find no chapter on taxation, whereas a new section entitled 'On the variation in the value of money in the same, and different countries' was inserted as Section 7 in Chapter 2.[4]

Thus – despite the facts that Malthus admitted the importance of the issue of taxation, that Ricardo recommended him to treat this subject, and that he planned to do so by attaching a new chapter on taxation in the second edition of the *Principles* – Malthus did not publish an independent chapter or section on public finance at any point during his life. Even in *Definitions in Political Economy* (1827), Malthus did not include taxation and public debt in the list of definitions.

In this chapter I will examine what problems Malthus would have faced if he had written a chapter on taxation for the second edition of the *Principles*. For this purpose I will compare Malthus's occasional statements concerning government expenditure, taxation, and public debt in the six editions of *An Essay on the Principle of Population* (1798–1826; henceforth *Essay*), both editions of the *Principles*, and his articles and pamphlets. Malthus's theories of taxation and public debt have rarely been discussed compared with his theories of population, effectual demand, value, and distribution.[5] Malthus has often been treated as a forerunner of Keynes, because Malthus insisted on the necessity of government expenditure to prevent economic depression (Thweatt, 1988: 75–7). In order to compare Malthus and Keynes more precisely, we have to know how Malthus dealt with financing government expenditure, that is, taxation and public debt.

The following section examines Malthus's references to the shifting and incidence of taxation, whereas the third section analyses his views of the macroeconomic effects of government expenditure, taxation, and public debt on the balance between production and consumption, and between population and food production. In the conclusion, I will argue that if Malthus had written a chapter on taxation, he would have had to demonstrate practically operational principles of public finance, which harmonized (1) the Smithian theory of tax incidence with the theory of differential rent, and (2) the demand-side theory of public finance with the principle of population.

5.2 The shifting and incidence of taxation

An early reference to the shifting and incidence of taxation can be found in a footnote in the second edition of the *Essay* (1803), Book 3, Chapter 9, 'Of the Definition of Wealth: Agricultural and Commerce Systems'. Here Malthus criticized the Physiocrats' doctrine:[6]

> One of the principal errors of the French Economists appears to be on the subject of taxation. Admitting, as I shall be disposed to do, that the surplus produce of the land is the fund which pays everything besides the food of the cultivators; yet it seems to be a mistake to suppose that the owners of land are the sole proprietors of this surplus produce.
>
> (Malthus 1989 [1803], vol. 1: 398)[7]

According to Malthus, not only landlords, but also the moneyed interest who owned capital in money and received interest, had 'virtually a mortgage on the land for a certain portion of the surplus produce' (Malthus 1989 [1803], vol. 1: 398). Thus, Malthus concluded:

> The landholders, therefore, are not the sole proprietors of surplus produce; and their joint proprietors, those who live upon the interest of money, certainly pay a general tax in the same manner as the landholders, and cannot throw it off from their shoulders, like those who live upon the profits of stock or the wages of labour.
>
> (Malthus 1989 [1803], vol. 1: 398)

Even if all taxes had fallen on land, it did not mean that they would be paid by landlords (or their rent) alone.[8]

Malthus also thought that practically, 'it cannot be doubted that even the profits of stock and the wages of labour, particularly of professional labour, pay some taxes on necessaries, and many on luxuries, for a very considerable time' (Malthus 1989 [1803], vol. 1: 398). Thus, in 1803, Malthus acknowledged that, in opposition to the Physiocrats' doctrine, a considerable portion of taxes could actually be paid from forms of income other than rent, such as the interest of money, profits of stock and wages of labour. However, subsequently, this footnote was altered twice and finally eliminated when Malthus fully rewrote Chapters 7 through 10 of Book 3 in the fifth edition of the *Essay* (1817).

In the third edition of the *Essay* (1806), Malthus added a new footnote in Chapter 10 of Book 3, saying that '[t]axes which affect capitals in trade are almost immediately shifted off on the consumer; but taxes which affect agricultural capital fall, during the current leases, wholly on the farmer' (Malthus 1989 [1803], vol. 1: 405). Malthus thought that taxes levied on agricultural capital would discourage improvement of the land and would consequently lower rent. Nevertheless, Malthus noted that 'the high price of labour or taxes on agricultural capital ultimately fall on the rent' (Malthus 1989 [1803], vol. 1: 405). This footnote was also removed in the 1817 edition.

In *An Inquiry into the Nature and Progress of Rent* (1815), Malthus demonstrated that taxes on agricultural capital could be shifted to consumers through an increase in the price of the product: 'every tax, which falls on agricultural capital, either prevents a proposed improvement, or causes it to be purchased at a higher price' (Malthus 1986 [1815a], vol. 7: 141). However, these effects would occur only temporarily. Although, in the short run, taxes on agricultural activities were paid from profits and wages, in the long run, they would fall on rent:

> When new leases are let, these taxes are generally thrown off upon the landlord. The farmer so makes his bargain, or ought to make it, as to leave himself, after every expense has been paid, the average profits of agricultural stock in the actual circumstances of the country, whatever they may be, and in whatever manner they may have been affected by taxes, particularly by so general a one as the property tax. The farmer, therefore, by paying less rent to his landlord on the renewal of his lease, is relieved from any peculiar pressure, and may go on in the common routine of cultivation with the common profits.
>
> (Malthus 1986 [1815a], vol. 7: 141)

It will become obvious that, fundamentally, Malthus followed Smith's theory of tax incidence, rather than that of the Physiocrats, if the above text is compared with Smith's statement concerning a tax levied on agricultural profits:

> The farmer, however, must have his reasonable profit as well as every other dealer, otherwise he must give up the trade. After the imposition of a tax of this kind, he can get this reasonable profit only by paying less rent to the landlord. The more he is obliged to pay in the way of tax, the less he can afford to pay in the way of rent. A tax of this kind imposed during the currency of a lease may, no doubt, distress or ruin the farmer. Upon the renewal of the lease it must always fall upon the landlord.
>
> (Smith 1976 [1776]: 856)

As was seen in Chapter 3 of this book, Smith demonstrated that taxes on agricultural products, manufactured necessities, profits and wages would reduce the rent of land. Although Smith did not accept the Physiocrats' definition of wealth, he concluded that the main taxpayers in the state were landlords. The last paragraph in Malthus's pamphlet on rent shares this Smithian view:

> Though it is by no means true, as stated by the Economists, that all taxes fall on the net rents of the landlords, yet it is certainly true that they are more frequently taxed both indirectly as well as directly, and have less power of relieving themselves, than any other order of the state. And as they pay, as they certainly do, many of the taxes which fall on the capital of the farmer and the wages of the labourer, as well as those directly imposed on themselves; they feel it in the diminution of that portion of the whole produce, which under other circumstances would have fallen to their share. But the degree in which the different classes of society are affected by taxes, is in itself a copious subject, belonging to general principles of taxation, and deserves a separate inquiry.
>
> (Malthus 1986 [1815a], vol. 7: 145)

Thus, following Smith, Malthus acknowledged that most (if not all) taxes would ultimately fall on the rent of land.[9] However, in contrast to Smith, Malthus did not put forward a consistent theory of tax incidence which could support his conclusion. In particular, Malthus did not indicate that his conclusion with respect to tax incidence was compatible with his theory of rent.

Prior to Ricardo, Malthus attempted to establish the theory of differential rent in his 1815 pamphlet. Malthus demonstrated the concept of what we call 'marginal land' as follows:

> From the preceding account of the progress of rent, it follows . . . that the price of produce, in every progressive country, must be just about equal to the cost of production on land of the poorest quality actually in use; or to the cost of raising additional produce on old land, which yields only the usual returns of agricultural stock *with little or no rent*.
>
> (Malthus 1986 [1815a], vol. 7: 132; emphasis added)[10]

If Malthus wanted to maintain Smith's theory of tax incidence, he had to demonstrate more clearly that the landlord of the marginal land had the capacity to pay a tax. In contrast, had Malthus accepted the Ricardian version of differential-rent theory – that marginal land produced *no* rent – he would have had to abandon Smith's theory of tax incidence. Ricardo, recognizing this problem, wrote a letter to Malthus in February 1815:

> I differ too, as you know, as to the effects of taxation on the growth of produce. You appear to me not quite consistent in admitting as you unequivocally do that the last portion of land cultivated, yields nothing more than the profits of stock, – no rent, and yet to maintain that taxes on necessaries or on raw produce fall on the landlord and not on the consumer.
>
> (Sraffa 1951–73, vol. 6: 173)

Ricardo thought that taxes levied on agricultural products, manufactured necessities, wages, and profits would ultimately fall on profits – not rent. The landlords would bear the burden only as consumers if these taxes raised the price of commodities. In contrast, a tax on rent and taxes on luxuries would not fall on profits. This conclusion was compatible with the theory of differential rent and the assumption that luxuries were not consumed by labourers. Thus, Ricardo developed a consistent theory of tax incidence on the basis of his theory of production and distribution (see Section 6.3, pages 119–31). Malthus replied to Ricardo as follows:

> With regard to the tax *being thrown off on* the Landlord I did not certainly express myself as I meant. I intended to alter it before I left Town but forgot it. It is now corrected. I think however there are often cases where taxes are thrown off on the landlord, and I meant to say that those which had not already been thrown off on the consumer would then be thrown off on the landlord.
>
> (Sraffa 1951–73, vol. 6: 176; emphasis in original)[11]

Malthus's reply presumably did not satisfy Ricardo, because it did not clearly demonstrate on whom taxes on agricultural products and necessities would finally fall – consumers, capitalists, or landlords.

After his unsuccessful reply to Ricardo, Malthus started to revise his early statements concerning tax incidence. First, as was shown above, in the 1817 edition of the *Essay* Malthus eliminated two footnotes which had appeared in the 1803 and 1806 editions. Second, when he used the 1815 pamphlet on rent for Chapter 3 of the *Principles* in 1820, Malthus eliminated the statements concerning taxes on agricultural capital. Meanwhile, the final paragraph (except for the concluding sentence) of the pamphlet – quoted above – was copied as the final paragraph of Section 7 in Chapter 3 of the *Principles*.[12] Thus, by 1820 Malthus had removed most of his early statements concerning the Physiocrats' doctrine of tax incidence, keeping the Smithian position demonstrated in the 1815 pamphlet.

In the Introduction to the *Principles*, Malthus argued that the difference between Smith's and the Physiocrats' theories of taxation stemmed from their different definitions of wealth:

> the difference of the Economists and Adam Smith were not mere differences in theory; they were not different interpretations of the same phenomena, which would have no influence on practice; but they involved such views of the nature and origin of wealth, as, if adopted, would lead, in almost every country, to great practical changes, particularly on the very important subject of Taxation.
>
> (Malthus 1989 [1820], vol. 1: 3)

Malthus's definition of wealth – 'those *material* objects which are necessary, useful, or agreeable to mankind' (Malthus 1989 [1820], vol. 1: 28; emphasis in original) – followed Smith's. Malthus thought that the Physiocrats 'have confined wealth, or riches, to the neat produce derived from the land; and in so doing they have greatly diminished the value of their inquiries' (Malthus 1989 [1820], vol. 1: 27).

In a letter to Thomas Chalmers dated 6 March 1832, Malthus wrote:

> With respect to the doctrine of the Economists on the incidence of all taxes upon the neat rents of the Landlords, which you seem to have adopted, I should agree with you, if the taxes were direct taxes upon wages and profits all the way through, which would raise both proportionally, and leave less for the owner of the soil; but I am inclined to think that the principal operation of indirect taxation, when well applied, is to take a portion of wealth from the *individuals* in the different classes who can spare it, without altering the general wages of labour or the general profits of stock, and without therefore falling upon the landlord.
>
> (James 1979: 432; emphasis in original)

In this letter, Malthus indicated that whereas taxes on wages and profits would fall on the rent of land, 'well-applied' indirect taxes would not do so. This conclusion was consistent with Smith's, if 'well-applied' indirect taxes meant taxes on luxuries.

Thus, Malthus kept the Smithian conclusion that most (if not all) taxes would ultimately fall on rent. However, the problem remained that such a conclusion was not compatible with the theory of differential rent. If Malthus wished to maintain the Smithian theory of tax incidence, he had to put forward a theory of rent which accommodated the possibility of positive rent on marginal land.[13]

5.3 The macroeconomic effects of government expenditure, taxation, and public debt

5.3.1 Early Malthus

Before the end of the Napoleonic Wars, Malthus took a fundamentally negative attitude towards government expenditure, taxation, and public debt. As the author of the first edition of the *Essay* (1798), Malthus did not support relief of the poor by imposing a rate – a kind of local tax – on the industrious class:[14]

> The poor laws of England tend to depress the general condition of the poor in these two ways. Their first obvious tendency is to increase population without increasing the food for its support. . . . Secondly, the quantity of provisions consumed in workhouses upon a part of the society, that cannot in general be considered as the most valuable part, diminishes the shares that would otherwise belong to more industrious, and more worthy members.
>
> (Malthus 1986 [1798], vol. 1: 33)

The above viewpoint was reinforced in the second edition (1803). According to Malthus, if the available provisions of the country remained constant, a transfer of money from the industrious class to the poor by means of the poor rate would raise the price of provisions, impoverish the labouring class, and consequently increase the number of the poor. Even if the quantity of provisions increased, this would increase population more than proportionally, and diminish the provisions per head of population. The poor supported by the assistance had no will to save, and the people in the industrious class on whom the heavy poor rate was imposed would lose a part of their power to save. 'The poor laws may, therefore, be said to diminish both the power and the will to save among common people, and thus to weaken one of the strongest incentives to sobriety and industry, and consequently to happiness' (Malthus 1989 [1803], vol. 1: 359). Hence, said Malthus, 'the first grand obstacle which presents itself in this country is the system of the poor laws' (Malthus 1989 [1803], vol. 1: 137).

Malthus believed that the poor rate not only prevented savings – capital accumulation – but also reduced levels of existing capital:

> It should be observed, in general, that when a fund for the maintenance of labour is raised by assessment, the greatest part of it is not a new capital brought into trade, but an old one, which before was much more profitably employed, turned into a new channel. . . . And this obvious tendency of assessments for the employment of the poor to decrease the real funds for the maintenance of labour in any country, aggravates the absurdity of supposing that it is in the power of a government to find employment for all its subjects, however fast they may increase.
>
> (Malthus 1989 [1803], vol. 1: 365)

Although in some parishes, the fund was used for the employment of the poor in a workhouse, '[t]he attempts to employ the poor on any great scale in manufactures have almost invariably failed, and stock and materials have been wasted' (Malthus 1989 [1803], vol. 1: 364). Some workhouses succeeded in producing manufactured goods. However, manufactures produced by the poor deprived many independent workmen of their markets. Although the productivity of the poor was lower than that of ordinary labour, this was the case because the poor's production was supported by a great bounty. In any case, the Poor Laws converted capital into less efficient uses.

Thus, Malthus criticized the Poor Laws because (1) they would raise the number of poor people by increasing the population and by impoverishing industrious classes, and (2) they would slow down capital accumulation by reducing savings and by converting existing capital into less efficient uses. Malthus concluded:

> If the poor's rates of England were suddenly abolished, there would undoubtedly be the most complicated distress among those who were before supported by them; but I should not expect that either the condition of the labouring part of the society in general, or the population of the country, would suffer from it.
>
> (Malthus 1989 [1803], vol. 1: 240)

Through six editions of the *Essay*, Malthus remained in favour of an abolition of the Poor Laws in the long run, although he occasionally acknowledged their significance as an emergency relief.

Malthus also criticized taxes on necessities and tithes. Taxes on necessities increased the prices of commodities, and consequently aggravated the condition of the labouring poor. Tithes discouraged the improvement in land, because they were imposed in proportion to the gross yield of agricultural products. In contrast, a land tax escaped this fault, if imposed in proportion to the net rent – in other words, if it could exempt returns on capital invested in improvements.[15] In the second edition of the *Essay*, Malthus argued:

> [A land tax] is the best of all taxes, as it is the only one which does not tend to raise the price of commodities. Taxes on consumption, by which alone monied revenues can be reached without an income tax, necessarily raise all prices to a degree greatly injurious to the country. A land tax, or a tax upon net rent, has little or no effect in discouraging the improvement of land, as many have supposed. It is only a tithe or a tax in proportion to the gross produce, which does this. . . . I am astonished that so obvious and easy a commutation for tithes, as a land tax on improved rents, has not been adopted.
>
> (Malthus 1989 [1803], vol. 1: 398)

Malthus's proposal to replace tithes with a land tax was restated in a stronger tone in his two anonymous articles in the *Edinburgh Review*, which reviewed Thomas Newenham's works – *A Statistical and Historical Inquiry into the Progress and Magnitude of the Population of Ireland* (1808) and *A View of the Natural, Political and Commercial Circumstances of Ireland* (1809). Considering the miserable situation of Irish tenants, to which Newenham did not give prescriptive remedies, Malthus wrote:

> We are no advocates for the territorial tax of the Economists; but we certainly think, that the peculiar state of Ireland calls upon the Legislature, by every principle of justice and policy, to remove the burden of the partial and oppressive county rates, and still heavier and more oppressive burden of tithes, from the poor tenantry, to the rich landlords. Such a measure would be an effective and permanent encouragement to agriculture; and would go further in allaying the discontents of Ireland, than any thing short of complete emancipation, – which, at all events, it ought to accompany.
>
> (Malthus 1963 [1809]: 68)

Although Macdowell (1977: 401–2) interprets the above proposal as a single-tax scheme,[16] we cannot find any (or at least, any other) textual evidence which supports the belief that Malthus proposed reducing *all* taxes to a *single* tax on land. In fact, Malthus only argued for replacing tithes and local rates with a tax on net rent. Probably Malthus had in mind Smith's variable-land-tax scheme rather than the Physiocrats' single-land-tax scheme.

On the issue of public debt, Malthus mentioned in the second edition of the *Essay* that it was injurious to the economy because it would raise the rate of interest, reduce new investment on land, and consequently impede the improvement of land:

> It is in this point, I am inclined to believe, that the national debt of England has been most injurious to bear. By absorbing the redundancy of commercial capital, and keeping up the rate of interest, it has prevented this capital from overflowing upon the soil. And a large mortgage has thus been established on the lands of England, the interest of which is drawn from the payment of productive labour, and dedicated to the support of idle consumers.
>
> (Malthus 1989 [1803], vol. 1: 397–8)[17]

It can be concluded that, at the early stage of his career, Malthus had a fundamentally negative view of the macroeconomic effects of government expenditure, taxation, and public debt: in particular, poor rates, tithes, and public debts impoverished the agricultural producers, and consequently impeded the improvement of land. Only a land tax, which would directly fall on idle consumers (landholders and land-mortgagees), could escape these faults. Malthus was always concerned with the macroeconomic effects of public finance on the balance between population and food production.

5.3.2 A transitional period: 1811–15

In this period Malthus became involved in purely economic controversies: debates over the Bullion Committee Report of 1811 and the reform of the Corn Laws in 1815. Malthus became acquainted with Ricardo through the bullion controversy. On the issue of taxation, Malthus began to admit that it could stimulate industry, though keeping unaltered his early standpoint in the *Essay* that taxation and public debt would disturb the growth of food production.

In the article entitled 'High price of bullion' (1811), Malthus stated for the first time that 'severe taxation is not so prejudicial to the resources of a state, as might naturally be expected', because 'the transfer of property occasioned by a rise of prices, has a tendency to give a stimulus to industry' (Malthus 1986 [1811], vol. 7: 74). However, Malthus never forgot to add that 'the principle itself cannot safely be received without considerable limitation' (Malthus 1986 [1811], vol. 7: 74).

Malthus thought that the Napoleonic Wars, during which heavy taxation was imposed and a huge public debt was accumulated, brought prosperity rather than distress to England. In November 1814, when the war was coming to an end, Malthus wrote to Ricardo:

> Accumulation of *produce* is not accumulation of *capital*, unless what is accumulated is worth more than it cost, and if you were at once to employ all our soldiers sailors and menial servants in productive labour, the price of produce would fall more than ten per cent, and the encouragement to employ the same quantity of capital would cease.
>
> (Sraffa 1951–73, vol. 6: 155; emphasis in original)

Thus, Malthus became concerned with the postwar depression which would be caused by a sudden contraction in consumption by those who had been supported previously by public revenue.

Although Malthus referred to taxation's positive effect on industry, this did not mean that he changed his fundamental viewpoint that heavy taxation – particularly a tax imposed on agricultural capital – would damage the balance of population and food. In the third and fourth editions of the *Essay* (1806 and 1807, respectively), Malthus maintained his standpoint in the second edition concerning the poor rates and tithes. In his letter to Ricardo on 5 August 1814, Malthus wrote that '[m]y objection to taxes upon necessaries compared with taxes on luxuries and income taxes on the higher classes of society, is, that they must diminish capital and produce' (Sraffa 1951–73, vol. 6: 118). In his 1815 pamphlet on rent, Malthus argued that taxes on agricultural capital would reduce the investment in improvement of the land (Malthus 1986 [1815a], vol. 7: 140–1).[18]

Malthus also referred to the issues of taxation and public debt in relation to the importation of foreign corn. In *The Grounds of an Opinion on the Policy of Restricting the Importation of Foreign Corn* (1815), Malthus argued that free importation of corn would sharply lower the general price level and hence would increase the real burden of interest payments on public debt. All those whose incomes varied in proportion to the general price level would incur an increased burden. Although stockholders would benefit from the fall in the general price level, in the long run, they would suffer in the event of a default. Malthus argued:

> If we consider, with what an increased weight the taxes on tea, sugar, malt, leather, soap, candles, etc., etc. would in this case bear on the labouring classes of society, and what *proportion* of their incomes all the active, industrious middle orders of the state, as well as the higher orders, must pay in assessed taxes, and the various articles of the customs and excise, the pressure will appear to be absolutely intolerable. . . . These are considerations sufficient to alarm even the stockholders themselves. Indeed, if the measure of value were really to fall, as we have supposed, there is great reason to fear that the country would be absolutely unable to continue the payment of the present interest of the national debt.
>
> (Malthus 1986 [1815b], vol. 7: 170; emphasis in original)

Considering that a sudden fall in the general price level could produce national bankruptcy, Malthus concluded that 'the necessary effect of a change in the measure of value on the weight of a large national debt is alone sufficient to make the question fundamentally different from that of a simple question about a free or restricted trade' (Malthus 1986 [1815b], vol. 7: 171). Thus, Malthus used the issues of public debt and taxation to reject free importation of foreign corn. Heavy taxation and a huge public debt were dangerous factors which would make deflation more intolerable to the nation.[19]

5.3.3 The fifth edition of the **Essay** *(1817)*

As was shown in Section 1.2.2 (pages 8–10), because of the Revolutionary and Napoleonic Wars, the outstanding public debt in Britain had more than tripled. The annual amount of taxes quadrupled, to more than 20 per cent of the gross national income. Now the problem was how to reduce the public debt, and lighten the tax burden. Without great retrenchment, it was difficult to accomplish these purposes simultaneously. Although the government wished to maintain the income tax in order to redeem the public debt, the people strongly resisted such a scheme. Consequently, in

1816, the government reluctantly repealed the income tax. This repeal paid back £14 million to the people. However, the hope of redeeming the public debt was lost in the postwar depression.

In this economic climate, Malthus wrote the fifth edition of the *Essay* (1817). In it, Malthus eliminated his early statements on the Physiocratic doctrine of taxation. However, in the newly added chapters, Malthus referred to the postwar depression in Britain, and analysed the economic consequences of the reduction in taxes and redemption of the public debt. In essence Malthus believed that a sudden reduction in taxes would diminish aggregate consumption, lower the price level, and consequently decrease demand for labour. Malthus did not believe that the postwar depression was directly produced by heavy taxes:

> The sufferings of the country since the peace have not been occasioned so much by the usual and most natural effects to be expected from war and taxation, as by the sudden ceasing of an extraordinary stimulus to production, the distresses consequent upon which, though increased no doubt by the weight of taxation, do not essentially arise from it, and are not directly therefore, and immediately, to be relieved by its removal.
>
> (Malthus 1989 [1803], vol. 2: 134–5)

The depression occurred because of a sudden contraction of the market for commodities. Because 'the specific evil of taxation consists in the check which it gives to production, rather than the diminution which it occasions in demand' (Malthus 1989 [1803], vol. 1: 371), the removal of taxation could not be an effective way to create a market for commodities.

Malthus did not think that government expenditure financed by taxes and public debt would diminish aggregate consumption:

> With regard to all commodities indeed of home production and home demand, it is quite certain that the conversion of capital into revenue, which is the effect of loans, must necessarily increase the proportion of demand to the supply; and the conversion of the revenue of individuals into the revenue of the government, which is the effect of taxes properly imposed, however hard upon the individuals so taxed, can have no tendency to diminish the general amount of demand. It will of course diminish the demands of the persons taxed by diminishing their powers of purchasing; but to the exact amount that the powers of these persons are diminished, will the powers of the government and of those employed by it be increased.
>
> (Malthus 1989 [1803], vol. 1: 371)

Consequently, public debt converted savings into consumption, whereas taxes simply transferred private consumption to public consumption. On the basis of this assumption, Malthus argued that a reduction of taxation would not increase the aggregate consumption, and that extinction of public debt would decrease it.[20]

A repeal of taxation, even if it did not reduce the aggregate consumption, would weaken the stimulus to industry because it would lower prices. Malthus argued:

> I feel the firmest conviction that if the whole of the taxes were removed to-morrow, this stagnation, instead of being at an end, would be considerably aggravated. Such an event would cause another great and general rise in the value of the circulating medium, and bring with it that discouragement to industry with which such a convulsion in society must ever be attended.
>
> (Malthus 1989 [1803], vol. 1: 371)

Malthus concluded in the fifth edition of the *Essay* that a reduction in taxation and public debt would aggravate the depression. However, Malthus continued to insist on the abolition of the Poor Laws – taxation to support the poor. Malthus also argued that one of the reasons why large quantities of foreign corn were imported was 'a system of direct or indirect taxation, of such an nature as to throw a weight upon the agriculture of a country' (Malthus 1989 [1803], vol. 2: 49). Heavy domestic taxes on agriculture hindered improvement of the land, kept the price of domestic corn high, and consequently increased the importation of foreign corn. As an opponent of the Poor Laws and as a supporter of the 1815 Corn Laws, Malthus regarded taxation – in particular upon agricultural capital – as a vice. Nevertheless, the fifth edition of the *Essay* is characterized as the book in which Malthus explicitly referred to a positive macroeconomic effect of taxation and public debt on the demand side, putting forward his opposition to their reduction.

5.3.4 The first edition of the **Principles** *(1820)*

In the *Principles*, Malthus treated the issues of government expenditure, taxation, and public debt from the viewpoint of their demand-creating effect. Malthus thought that a high rate of profit would act as a stimulus to the growth of production, and that, although excessive consumption would delay capital accumulation, unproductive consumption (or employment of unproductive labour) in some proportion was necessary to keep the rate of profit high. Wealth should be distributed among social classes so as to produce an optimal proportion between consumption and production – in other words, a proportion which maximized the rate of economic growth. Malthus called this proportion the 'intermediate point':

> If consumption exceed production, the capital of the country must be diminished, and its wealth must be gradually destroyed from its want

> of power to produce; if production be in a great excess above consumption, the motive to accumulate and produce must cease from the want of will to consume. The two extremes are obvious; and it follows that there must be some intermediate point, though the resources of political economy may not be able to ascertain it, where, taking into consideration both the power to produce and the will to consume, the encouragement to the increase of wealth is the greatest.
>
> (Malthus 1989 [1820], vol. 1: 9)

The concept of 'the intermediate point' was consistent with Malthus's main doctrine of political economy, called by Pullen (1982) 'the doctrine of proportions'.[21] The doctrine stated that 'all the great results in political economy, respecting wealth, depend upon *proportions*' (Malthus 1989 [1820], vol. 1: 432; emphasis in original). On the basis of this doctrine, Malthus designated the balance between consumption and production a key element in the continuous growth of the economy.

According to Malthus, the depression after the Napoleonic Wars was produced because of a sudden diminution in aggregate consumption:

> The two last years of the war were . . . years of extraordinary expense, and being followed immediately by a period marked by a very unusual stagnation of demand, the destruction of capital which took place in those years was not probably recovered. But this stagnation itself was much more disastrous in its effects upon the national capital, and still more upon the national revenue, than any previous destruction of stock.
>
> (Malthus 1989 [1820], vol. 1: 493)

Malthus indicated three possible measures for rescuing the British economy from the postwar depression: (1) the division of landed property; (2) an extension of foreign trade; (3) maintenance of unproductive consumers.

Malthus believed that the division of landed property – to a certain extent – would increase the average propensity to consume (Malthus 1989 [1820], vol. 1: 431–3). However, Malthus rejected a change in the English law of inheritance – the law of primogeniture – into the French system of equal division. Such a system would divide land too minutely, impoverish landlords, and consequently diminish their consumption. It would also remove the incentive of the industrious classes to compete with rich landlords. Moreover, a decline in the influence of the landed class in Parliament would make the government a military despotism, or a monopoly of the mercantile class. Considering constitutional stability, as well as economic growth, Malthus concluded that 'the abolition of the law of primogeniture would produce more evil than good', and that 'there is no other way in which a different division of land could be effected' (Malthus 1989

[1820], vol. 1: 507). To Malthus, the division of landed property was not a practical measure against the depression.

The second measure was to extend foreign markets by giving more freedom to trade. This measure would increase not only national wealth, but also government revenue through moderate customs duties:

> While it is necessary to raise a large sum by taxation for the expenses of the government and the payment of the interest of the national debt, it would by no means be advisable to neglect so fair and fruitful a resource as the customs. . . . But there seems to be no reason for the absolute prohibition of any commodities whatever; and there is little doubt that, upon this principle, a much greater freedom might be given to foreign commerce, at the same time that a greater revenue might be derived from the customs.
>
> (Malthus 1989 [1820], vol. 1: 508)

However, Malthus did not neglect to make a reservation:

> those foreign commodities should be taxed the highest, which are either of the same kind as the native commodities which have been taxed, or such as, for special reasons of health, happiness, or safety, it is desirable to grow largely at home.
>
> (Malthus 1989 [1820], vol. 1: 508)

Corn was the most important commodity that had to be protected by high customs duties. Free importation of corn would lower the general price level, and increase the real burden of the interest payment on public debt. It would also reduce domestic production of corn, the rent of land, and consequently the landlords' consumption. All these factors would aggravate – rather than improve – the postwar economy. Thus, Malthus did not accept abolition of the Corn Laws. Moreover, although Malthus acknowledged that liberalization of trade would generally increase national wealth, he followed Smith's 'wise caution' that trade should be liberalized carefully and gradually (Malthus 1989 [1820], vol. 1: 509). Malthus believed that an extension of foreign trade should not be used as a short-run policy.

The third measure – maintenance of unproductive consumers – would be more practical and effective in the short run. Because Malthus did not believe that landlords and stockholders would increase their consumption sufficiently to compensate for the diminution in aggregate consumption, he claimed government expenditure:

> the employment of the poor in roads and public works, and a tendency among landlords and persons of property to build, to improve and beautify their grounds, and to employ workmen and menial servants,

> are the means most within our power and most directly calculated to remedy the evils arising from that disturbance in the balance of produce and consumption, which has been occasioned by the sudden conversion of soldiers, sailors, and various other classes which the war employed, into productive labourers.
>
> (Malthus 1989 [1820], vol. 1: 512)

Malthus acknowledged that this measure would prevent population from being adjusted to the demand for labour in the private sector. However, Malthus avoided this problem by stating that such a disturbance 'might be, in a considerable degree, corrected by the wages given' (Malthus 1989 [1820], vol. 1: 511–12).

Upholding the necessity of government expenditure in a depression, Malthus also claimed that a reduction in domestic taxes and public debt would cause a distribution of wealth that was unfavourable to the balance of consumption and production. Malthus thought that national wealth had been stimulated by the consumption of those who had been supported by taxes, and that the 'returned taxes, and the excess of individual gains above expenditure, which were so largely used as revenue during the war, are now in part, and probably in no inconsiderable part, saved' (Malthus 1989 [1820], vol. 1: 499). Thus, Malthus concluded:

> when, either from necessity or error, a different distribution has taken place, and the evil, as far as it regards private property, has actually been committed, it would surely be most unwise to attempt, at the expense of a great temporary sacrifice, a return to the former distribution, without very fully considering whether, if it were effected, it would be really advantageous; that is, whether, in the actual circumstances of the country, with reference to its powers of production, more would not be lost by the want of consumption than gained by the diminution of taxation.
>
> (Malthus 1989 [1820], vol. 1: 481)[22]

The *Principles* departed from the argument of the 1817 edition of the *Essay* in assuming that government expenditure financed by taxes and public debt would convert savings into consumption. On the basis of this assumption, Malthus reasoned that a reduction in taxation would diminish consumption and increase savings – this meant a conversion of unproductive labour into productive labour – and would consequently aggravate the postwar depression. In such a depression, the labouring class would be wounded most severely because of insufficient demand for labour. Consequently, in Malthus's view, 'to the working classes, no taking off of taxes, nor any degree of cheapness of corn, can compensate a want of demand for labour' (Malthus 1989 [1820], vol. 1: 521).

Malthus showed a similar attitude towards an extinction of public debt.

Public debt had created the moneyed interest, which Malthus called 'the middle class'. According to Malthus, because their propensity to consume was larger than that of landlords:

> the incomes which are received and spent by the national creditors are more favourable to the demand for the great mass of manufactured products, and tend much more to increase the happiness and intelligence of the whole society, than if they were returned to the landlords.
> (Malthus 1989 [1820], vol. 1: 484)

Because the interest on the public debt was paid by taxation imposed on other classes of society, the extinction of public debt would have had the same distributive effect as a reduction in taxation, if public creditors suddenly disappeared. This distributive effect would diminish aggregate consumption:

> I feel perfectly convinced that, if a spunge could be applied to it [public debt] to-morrow, and we could put out of our consideration the poverty and misery of the public creditors, by supposing them to be supported comfortably in some other country, the rest of the society, as a nation, instead of being enriched, would be impoverished. . . . The new distribution of produce would diminish the demand for the results of productive labour; and if, in addition to this, more revenue were converted into capital, profits would fall to nothing, and a much greater quantity of capital would emigrate, or be destroyed at home, and a much greater number of persons would be starving for want of employment, than before the extinction of the debt.
> (Malthus 1989 [1820], vol. 1: 486)

The extinction of public debt would increase savings in the economy by eradicating the moneyed interest and by reducing taxation imposed on other classes. However, this conclusion was derived from an assumption which ignored the problem of how public debt was to be paid off. Malthus did not indicate the means of redemption and its effect on the economy.[23]

Although Malthus regarded government expenditure as necessary to balance consumption and production, and was opposed to a reduction in taxation and public debt because it would aggravate the postwar depression, he never positively proposed an increase in taxation and public debt. Malthus warned that a huge public debt was injurious to the economy because: (1) its interest had to be paid by taxation; (2) it would render the people's property and revenue insecure; and (3) changes in the price level would affect the share of the national product going to creditors – owners of fixed incomes in terms of money – and tax payers. For these reasons, Malthus asserted that ‘it might be desirable slowly to diminish the debt, and to discourage the growth of it in the future’ (Malthus 1989 [1820], vol. 1: 485).

Similarly, Malthus showed that he never took sides on taxation. Malthus clearly stated:

> taxes should never be imposed, nor to a greater amount, than the necessity of the case justifies, and . . . every effort should be made, consistently with national honour and security, to prevent a scale of expenditure so great that it cannot proceed without ruin, and cannot be stopped without distress.
>
> (Malthus 1989 [1820], vol. 1: 519)

Moreover, after showing the injurious effects of a sudden reduction in taxation, Malthus concluded:

> To state these facts is not to favour taxes; but to give one of the strongest reasons against them; namely, that they are not only a great evil on their first imposition, but the attempt to get rid of them afterwards, is often attended with fresh suffering.
>
> (Malthus 1989 [1820], vol. 1: 521)

Malthus’s position in 1820 can be summarized as follows: taxes should not be imposed, and public debt should not be issued; but if they exist at all, they should not be reduced suddenly, but eliminated only gradually.[24]

Malthus’s moderate attitude towards taxation and public debt can be ascribed to uncertainty produced by his doctrine of proportions. Malthus suggested that an optimal level of taxes and public debt existed somewhere that was consistent with ‘the intermediate point’ between consumption and production. However, like ‘the intermediate point’, the optimal level of taxes and public debt could not be ascertained by political economy. Malthus recognized that the doctrine of proportions would make political economy and its application – for example to public finance – uncertain:

> In reference to the main doctrine . . . that the progress of wealth depends upon proportions; it will be objected, perhaps, that it necessarily opens the way to differences of opinion relating to these propositions, and thus throws a kind of uncertainty over the science of political economy which was not supposed to belong to it. . . . We cannot make a science more certain by our wishes or opinions; but we may obviously make it much more uncertain in its application, by believing it to be what it is not.
>
> (Malthus 1989 [1820], vol. 1: 515)

However, Malthus did not think that uncertainty produced by the doctrine of proportions would hinder the practicability of political economy:

> Though we cannot . . . lay down a certain rule for growing rich, and say that a nation will increase in wealth just in the degree in which it saves from its revenue, and adds to its capital; yet even in those parts which relate to the proportions of production and consumption, we are not left without guides.
>
> (Malthus 1989 [1820], vol. 1: 515–16)[25]

Malthus believed that 'the doctrine of proportion' would prevent political economists from extreme – namely unrealistic – proposals. In fact, considering the situation in Britain after the end of the Napoleonic Wars, with a huge public debt and intolerable tax burden, Malthus refrained from proposing a further increase in taxes and public debt. Moreover, considering the postwar economy in which consumption appeared to be below 'the intermediate point', Malthus did not support a sudden reduction of taxes and public debt. Thus, the doctrine of proportions gave Malthus a practical guide to taxes and public debt: they should be neither increased nor reduced rashly.

Malthus viewed government expenditure, taxes, and public debt not only in relation to the proportion between consumption and production, but also in relation to the proportion between population and food production. Until the last edition of the *Essay* (1826), Malthus did not fundamentally revise his early statements on the Poor Laws. Malthus did not regard them as an effective form of relief for the poor, thinking that heavy taxes and rates would reduce savings, impede improvement of the land, and consequently delay the increase in food production relative to the level of population. However, in the *Principles*, Malthus suggested that, by employing the poor on roads and public works, the government could prevent the economy from falling into further distress. Thus, the problem could arise of whether the unproductive poor supported by taxes and public debt would impede or contribute to the continuous growth of the economy. Malthus did not clearly answer this problem.

5.3.5 After the first edition of the **Principles**

Soon after the publication of the first edition of the *Principles*, Malthus started to revise it for the second edition (Malthus 1989 [1820], vol. 1: xxxvii). The most significant alteration regarding taxation and public debt in the second edition is that Malthus eliminated several paragraphs which showed that the extinction of public debt would reduce consumption (Malthus 1989 [1820], vol. 1: 485–8).[26] This may signify that, in the second edition of the *Principles*, Malthus placed less stress on the demand-creating effect of public debt made by the moneyed interest. However, no other significant alterations were made in the second edition with respect to taxation and public debt. This held true also with respect to the sixth edition of the *Essay* (1826).

In the 1820s and 1830s, Malthus published several works concerning political economy, but they contained no significant references to taxation and public debt.[27] For example, in *Definitions in Political Economy* (1827) Malthus never mentioned this subject. In the 1820s and 1830s, Malthus seemed to shift towards the issues of the measure of value and the method of political economy instead of developing the theory of public finance.

5.4 Conclusion

On the issue of tax incidence, Malthus followed Smith – rather than the Physiocrats – in concluding that most taxes would ultimately fall on rent. However, in order to make this conclusion consistent with the theory of differential rent, Malthus had to demonstrate more clearly that the landlord of marginal land received a positive rent.

With respect to the macroeconomic effects of government expenditure, taxation, and public debt, Malthus held dual views. As an opponent of the Poor Laws, Malthus maintained, in the *Essay*, that taxes and rates – in particular on agricultural capital – should be minimized in order to prevent food production from declining. Malthus thought that relief of the poor by taxes and rates would accelerate population and aggravate the condition of the poor. In contrast, in the *Principles*, Malthus outlined a demand-side view of public finance, arguing that unproductive expenditure by government was necessary to give incentives to capital accumulation. Although, considering the British fiscal situation, Malthus did not positively propose a further increase in taxes and public debt, he rejected a sudden reduction in taxes and public debt in the postwar depression. Both his negative and positive views of public finance stemmed from the doctrine of proportions. However, Malthus did not indicate that these views had to be consistently synthesized.

Thus, Malthus left his various views on government expenditure, taxation, and public debt in a muddle, without integrating them into a simple and clear-cut theory.[28] If he had written a chapter on taxation, Malthus would have had to demonstrate general principles of public finance which harmonized (1) the Smithian theory of tax incidence with the theory of differential rent and (2) the demand-side theory of public finance with the principle of population. If Malthus had been interested in abstract principles alone, it would not have been impossible for him to develop consistent principles of public finance. For example, Malthus could have argued that, in the short run, government expenditure, taxation, and public debt should be adjusted in order to balance consumption and production, whereas, in the long run, they should be restricted in order to prevent population from growing faster than food production. However, such an argument with respect to the short run and long run would have been practically useless. To Malthus, the principles of public finance had to be not only theoretically consistent, but also practically operational. They had to be founded on extensive experience, as well as the doctrine of proportions.

Notes

1 This chapter draws on Dome (1997).

2 Malthus continued to write: ‘It is well known that, if the theory of the Economists were true, all taxes should be laid on land; and it depends entirely upon the general laws which regulate the wages of labour, the profits of stock, the rent of land, exchangeable value, the currencies of different countries, the production and distribution of wealth, &c. &c. whether any existing system of taxation be the best, or whether it might be altered for the better’ (Malthus 1989 [1820], vol. 1: 20). Malthus did not accept the Physiocrats’ system of political economy which concluded a single tax on land.

3 See ‘Introduction to the Variorum Edition’ (Malthus 1989 [1820], vol. 1: xv–lxix). John Pullen collates the differences between the first edition of the *Principle*, the second edition, and the Manuscript Revision, giving precise comments.

4 Pullen points out that ‘[t]he alterations in the second edition of the *Principles* are more frequent and more extensive in the earlier chapters than in the later ones’ (Malthus 1989 [1820], vol. 1: lxv). Pullen gives several explanations for this uneven distribution. One is that the anonymous editor of the second edition may have left out some of the alterations made by Malthus. Another possibility is that Malthus did not have time to complete the alterations before his death. Malthus’s statements regarding taxation and public debt occur mainly in the later chapters.

5 There is no mention of the subjects of taxation and public debt even in comprehensive works on Malthus such as Bonar (1966 [1885]), Rashid (1987), Winch (1987), Dupâquier and Grebenik (1983), and Turner (1986). Although James (1979), Petersen (1979), and Hollander (1997) occasionally refer to Malthus on taxation, they devote no separate section to this subject. Hollander (1969) examines Malthus’s views on public works relating to the post-Napoleonic depression.

6 According to Hollander (1992: 369), ‘Malthus had access to a wide range of Quesnay’s works and, possibly, a wide range of other Physiocratic writings’.

7 The first sentence of the quotation was rewritten in the 1807 edition as follows: ‘The great practical error of the Economists appears to be on the subject of taxation; and this error does not necessarily flow from their *confined and inadequate definition of wealth*, but is a false inference from their own premises’ (Malthus 1989 [1803], vol. 1: 399; emphasis added). This change signifies that, by 1807, Malthus had departed from the Physiocrats’ doctrine that land alone produced the surplus produce.

8 Emphasizing the physiocratic bias in Malthus, Hollander (1997: 361) states that ‘Malthus maintained the physiocratic notion that *taxation incidence falls solely on the agricultural surplus*, thereby supplementing the notion of surplus as net income *disposable for capital accumulation* . . . but insisted on the empirical fact that surplus cannot be identified with land rent’ (emphasis in original).

9 Malthus taught Political Economy at East India College from 1805–34 using Smith’s *Wealth of Nations* as a text. Hashimoto (1988) reproduces Malthus’s

examination papers on Political Economy and on Modern History set in 1808, and the Inverarity Manuscript – a transcript of the 1830 lecture taken by Jonathan Duncan Inverarity (one of Malthus's students). The examination papers and Inverarity Manuscript contain several items on Smith's theory of tax incidence. They indicate that Malthus taught Smith's theory of tax incidence as an orthodox theory. See Hashimoto (1988: 25–6 and 84–6).

10 This text was copied in the first edition of the *Principles* (Malthus 1989 [1820], vol. 1: 183). Ricardo complained that Malthus did not definitely say that no rent would be paid for additional capital on the marginal land: 'There may then be some additional produce which yields no rent to the landlords. In examining the principles of taxation this doctrine is most important, and indeed is material to every part of the science of Political Economy' (Sraffa 1951–73, vol. 2: 167).

11 Malthus to Ricardo, 12 February 1815.

12 On this paragraph in the *Principles*, Ricardo commented that 'Mr. Malthus would find it difficult to prove this', asking, 'What taxes on the capital of the farmer do they [landlords in marginal land] pay?' (Sraffa 1951–73, vol. 2: 184).

13 Hollander (1997: 407) notes that 'the explicit allowance for diminishing returns in 1814/15 does not undermine the physiocratic bias, since even marginal land is said to yield rent'. In fact, in his 1815 pamphlet on rent, Malthus argued that whenever 'the instruments of production become cheaper, and the difference between the price of produce and expenses of cultivation increases, rents naturally rise' (Malthus 1986 [1815a], vol. 7: 129). Consequently, a continuous technological progress may render the rent of marginal land positive. However, Malthus did not explicitly use this argument in order to support his theory of tax incidence.

14 The poor rate in Malthus's time was usually imposed on users – rather than owners – of rateable property, although the mode of assessment varied depending on counties and parishes. Because the values of houses and land were most easily assessed, the poor rate was practically a tax levied on houses, land, and capital invested in land. For a brief explanation concerning the general mode of assessment in the poor rate see, for example, Ricardo (1951–73 [1817], vol. 1: 257–60) and McCulloch (1995 [1845]: 469). For a detailed history of English poor laws in Malthus's time, see Nicholls (1898: 97–236) and Poynter (1969: 106–85).

15 Malthus did not indicate how to distinguish returns on capital invested in land from the gross rent. For McCulloch's claim that it was impracticable to assess a net rent, see Section 7.4.1 (page 149).

16 Macdowell (1977: 401–2) emphasizes the similarity of Malthus's and Henry George's ideas on the issue of Irish tax reform. However, it must be noted that whereas Henry George – the founder of the single-tax movement in the United States of the late nineteenth century – used the Ricardian theory of tax incidence, Malthus fundamentally kept the Smithian theory of tax incidence.

17 These sentences were eliminated in the 1817 edition of the *Essay*.

18 This argument was eliminated when Malthus used the pamphlet on rent for the first edition of the *Principles*. Compare Malthus (1989 [1820], vol. 1: 192–9).

19 Ricardo argued that a fall in the price of corn would not proportionally lower the general price level, and that taxpayers would benefit from a fall in the general price level because their real purchasing power would increase (see Section 6.4.1, page 131). In his first book – *An Essay on a Reduction of the Interest of the National Debt* (1816) – McCulloch used Malthus's argument in order to propose a reduction in the interest on public debt (see Section 7.6, page 165).

20 Hollander (1969: 331) interprets Malthus in the *Essay* as thinking that 'funds

diverted from private capital projects to public capital projects, or from private revenue expenditure to public works, would have no effect on effectual demand', and shows that in the *Principles*, on the other hand, 'a case of funds diverted from private capital projects to public works was considered and a positive effect on effectual demand was noted'. However, in the fifth edition of the *Essay*, Malthus had already acknowledged that government expenditure was financed partly by converting private capital into government revenue; this conversion would increase effectual demand.

21 Pullen argues that '[a]lthough Malthus did not use the term "optimum", his doctrine of proportions is essentially the same as the concept of the optimum' (Pullen 1982: 271), and that 'his persistent use of the doctrine proves that it was not just a fleeting notion or a literary device, and suggests that an appreciation of the doctrine is essential for a proper interpretation of his thought' (Pullen 1982: 278). Pullen includes optimal levels of taxation and public debt in the list of problems to which Malthus applied the doctrine of proportions.

22 Ricardo commented: 'This argument in favour of taxation is quite consistent with Mr. Malthus's opinion of the advantages resulting from unproductive consumption. Mr. Malthus is a most powerful ally of the Chancellor of the Exchequer' (Sraffa 1951–73, vol. 2: 433).

23 Ricardo did not accept that the issue (extinction) of public debt would create (eradicate) a specific class of society: 'How does the national debt *create* the middle classes of society? Must not every holder of stock have been possessed of the same amount of property before he became a stockholder? Would he not then have been in the middle class of society if there had been no national debt? I cannot conceive how Nat[iona]l debt can have *created* any of this class. If again we pay it off, do we annihilate this middle class as Mr. Malthus appears to fear we should do? Will not every stockholder be in possession of a capital after payment of the debt [?]' (Sraffa 1951–73, vol. 2, 444–5; emphasis in original). It should be noted that, whereas Malthus – who was sometimes abused as a professional sycophant to the landed aristocrats – emphasized the demand-creating effect of the moneyed interest, Ricardo – who had been a stockjobber in the City – did not acknowledge such a positive role for the moneyed interest.

24 Malthus argued: '[taxes] are like those injudicious regulations of the mercantile system noticed by Adam Smith, which, though acknowledged to be pernicious, cannot be removed without producing a greater evil for an interval of considerable length' (Malthus 1989 [1820], vol. 1: 521).

25 Malthus also argued: 'the science of political economy bears a nearer resemblance to the sciences of morals and politics, than to the science of mathematics. But this truth, though it detracts from its certainty, does not detract from its importance. . . . The study of it is calculated to be of great practical use, and to prevent much positive evil. And if its principles be carefully founded on an experience sufficiently extended, we have good reason to believe, from what they have already done, that, when properly applied, they will rarely disappoint our just expectations' (Malthus 1989 [1820], vol. 1: 518).

26 The last two sentences of the last paragraph on p. 485, four paragraphs on pp. 486–8, and the first two sentences of the last paragraph on p. 488 in the first edition of the *Principles* were eliminated in the second edition. Pullen regards this alteration as influenced by Ricardo's critical comments on Malthus's argument that a redemption of public debt would reduce aggregate consumption (Malthus 1989 [1820], vol. 2: 463).

27 In a letter to Chalmers dated 6 March 1832, Malthus wrote that 'I am decidedly of opinion … that [as a means to raise money required for a war within the year] a property tax is a very good tax and might be substituted advantageously

for many others' (James 1979: 432). However, Malthus did not publish this opinion.

28 This would support Pullen's view of Malthus's general attitude towards economic theory and economic policy: 'Since reality for Malthus was a matter of proportion or balance, and was not simple and clear-cut, economic theory and economic policy could not be simple and clear cut. The "muddle" was as much in reality itself as in Malthus's thinking about the reality' (Pullen 1982: 283).

6 David Ricardo[1]

6.1 Introduction

The main purpose of David Ricardo's *Principles of Political Economy, and Taxation* (1817; henceforce *Principles*) was to elucidate the laws which regulated the natural rates of rent, profit, and wages. In particular, a new theory of rent – a theory of differential rent – provided the foundation of a consistent explanation of value, distribution, and growth. It also produced different conclusions to Smith's about the effects of taxation. In the 'Preface', Ricardo wrote:

> In 1815, Mr. Malthus, in his 'Inquiry into the Nature and Progress of Rent', and a Fellow of University College, Oxford, in his 'Essay on the Application of Capital to Land', presented to the world, nearly at the same moment, the true doctrine of rent; without a knowledge of which, it is impossible to understand the effect of the progress of wealth on profits and wages, *or to trace satisfactorily the influence of taxation on different classes of the community; particularly when the commodities taxed are the productions immediately derived from the surface of the earth*. Adam Smith, and other able writers to whom I have alluded, not having viewed correctly the principles of rent, have, it appears to me, overlooked many important truths, which can only be discovered after the subject of rent is thoroughly understood.
>
> (Ricardo 1951–73 [1817], vol. 1: 5–6; emphasis added)

Ricardo was greatly concerned with taxation, as well as value, distribution, and growth. The full title of the *Principles* is sufficient proof of this. In fact, Ricardo devoted almost one-third of the *Principles* to taxation, examining the effects and incidence of various taxes. From his abstract analysis of taxation, however, Ricardo derived no positive proposals as to how government should raise ordinary revenue.[2] Ricardo's main conclusion was simply that 'taxation under every form presents but a choice of evils' (Ricardo 1951–73 [1817], vol. 1: 167). However, there was one exception to this negative view of taxation. Ricardo proposed a capital levy (a lump-sum tax on property) to redeem outstanding public debt. Ricardo suggested it first in the *Principles*, and later in his article on the 'Funding system' (1820).[3]

In this chapter, I shall examine why Ricardo concluded that every tax was an evil. I shall also demonstrate that his proposal of a capital levy did not contradict his generally negative opinion of taxation. The following section will discuss Ricardo's negative view of government expenditure. In the third section, it will be shown that in Ricardo's system of political economy, no tax could satisfy his main criteria for taxation, and that most taxes would fall on the profits of capital. In the fourth section, the reasons will be clarified why Ricardo relied on a capital levy – not the sinking fund – in order to redeem public debt. This chapter will conclude that Ricardo can be characterized as the first opponent of taxation.

6.2 Government expenditure

Ricardo's *Principles* had no chapters on items of government expenditure such as defence, justice, and public works, all of which Smith had discussed in detail in the *Wealth of Nations*. Moreover, in contrast to Malthus, Ricardo did not believe that government expenditure would promote economic growth. To Ricardo, government expenditure was a transformation of private consumption or private savings into government consumption, and '[i]t is by the profuse expenditure of Government, and of individuals . . . that the country is impoverished' (Ricardo 1951–73 [1817], vol. 1: 246). Hence, Ricardo did not hesitate to accept Say's golden maxim that 'the very best of all plans of finance is to spend little' (Ricardo 1951–73 [1817], vol. 1: 235).[4]

Ricardo's negative opinion of government expenditure did not change after the *Principles*. For example, in a letter to Hutches Trower in 1819, Ricardo wrote:

> Political Economy, when the simple principles of it are once understood, is only useful, as it directs Governments to right measures in taxation. We very soon arrive at the knowledge that Agriculture, Commerce, and Manufactures flourish best when left without interference on the part of Government, but the necessity which the state has for money to defray the expences of its functions, imposes on it the obligation to raise taxes, and thus interference becomes absolutely necessary. It is here then that the most perfect knowledge of the science is required.
>
> (Sraffa 1951–73, vol. 8: 132–3)

In his letter to Trower in 1820, Ricardo offered a more positive opinion of some public works: 'Taxes for the benefit of trade itself such as for Docks, canals, Roads, &c. &c. are on a different footing from all other taxes, and produce very different effects, they may and generally do promote production instead of discouraging it' (Sraffa 1951–73, vol. 8: 155). However, Ricardo did not publicize this opinion. At least as a formal opinion, Ricardo maintained that government expenditure – a kind of government interference – had to be minimized, and that knowledge of political economy should be used in order to find the least harmful system of taxation.[5]

6.3 Taxation as a choice of evils

6.3.1 Early Ricardo

Ricardo's early statements on taxation were made in a pamphlet entitled *Reply to Mr. Bosanquet's Practical Observation on the Report of the Bullion Committee* (1811). Criticizing Charles Bosanquet's claim that the sharp rise in the general price level since 1793 could be ascribed to heavy taxes alone, Ricardo declared that taxes would not always raise prices:

> it appears convincingly certain, that neither the income tax, the assessed taxes, nor many others, do in the least affect the prices of commodities. Unfortunate indeed would be the situation of the consumer, if he had to pay additional prices for those commodities which were necessary to his comfort, after his means of purchasing them had been by the tax considerably abridged. The income tax, were it fairly imposed, would leave every member of the community in the same relative situation in which it found him. Each man's expences must be diminished to the amount of his tax.
>
> (Ricardo 1951–73 [1811], vol. 3: 241)[6]

The above quotation displays Ricardo's three concerns with respect to taxation: whether a tax would (1) keep prices unchanged; (2) be paid from consumption or savings; (3) leave the distribution of income unchanged. Let us call these criteria 'the principle of price neutrality', 'the principle of consumption reducibility', and 'the principle of distribution neutrality', respectively.[7]

The principle of distribution neutrality illustrates Ricardo's concept of 'equality' in taxation, which was different from Smith's – proportionality to taxpayers' ability to pay. The principle of consumption reducibility indicates his concern to minimize impediments to capital accumulation. The principles of price neutrality and consumption reducibility belonged to Smith's maxim of 'economy'. A tax which infringed these two principles would impose a greater burden on the people than the amount of the tax they paid. The above quote indicates that Ricardo thought an income tax observed the principles of distribution neutrality and price neutrality to a greater degree than indirect taxes. Because an income tax was expected to be paid from consumption rather than savings, it would not infringe the principle of consumption reducibility. Ricardo believed that an income tax would satisfy the three criteria.

In *An Essay on the Influence of a Low Price of Corn on the Profits of Stock* (1815; henceforth *Essay on Profits*), Ricardo criticized Malthus's opinion that the free importation of foreign corn would ruin national prosperity. Ricardo claimed that free trade would produce national prosperity by reducing the domestic price of corn, lowering money wages, raising profits, and promoting capital accumulation. Although Ricardo did not directly refer to customs duties, his conclusion implied that he did not regard them as desirable.

What opinions did Ricardo hold concerning Pitt's income tax? Ricardo was writing the *Principles* when debate heated up in Parliament concerning the continuation or abolition of the income tax. In a letter to Trower dated 9 March 1816, nine days before the income tax was repealed, Ricardo referred to the Chancellor's final proposal for retention of the tax:

> I hope you will bring up a petition with you against the property tax. It is more objectionable I think as a 5 percent than as a 10 percent tax, yet I would willingly submit to it if I thought that it would really end in two years. The machinery of it is too easily worked to allow it to be at the disposal of our extravagant ministers during a period of peace.
>
> (Sraffa 1951–73, vol. 7: 27)

This is Ricardo's only reference to Pitt's income tax.[8] It shows that Ricardo preferred an income tax of 10 per cent for two years to 5 per cent over a longer period. Probably Ricardo considered the retention of the income tax for a definite period a measure for redeeming the public debt, but that a long-term income tax would be used for wasteful purposes.

6.3.2 The first edition of the **Principles** *(1817)*

In the chapters on taxation in the *Principles*, Ricardo adopted Smith's maxims of 'certainty' and 'convenience', as well as his own principles of price neutrality, distribution neutrality, and consumption reducibility. Studying the effects and incidence of various taxes, Ricardo concluded that no tax could simultaneously satisfy all these maxims and principles. Let us examine first indirect taxes – taxes on raw produce (i.e. agricultural product), manufactured necessities, and manufactured luxuries. Direct taxes – taxes on rent, wages, and profit – will be discussed in the subsequent section.

6.3.2.1 Indirect taxes

A tax on raw produce would raise its price by the amount of the tax, leaving the prices of other commodities unchanged. Such a tax would increase money wages, and consequently reduce the uniform rate of profit in all industries (Ricardo 1951–73 [1817], vol. 1: 159–60 and 243). This conclusion – as well as conclusions about other taxes – was based on the following assumptions: (1) a differential rent; (2) free movement of capital between all sectors; (3) inelasticity of demand for raw produce; (4) homogeneous units of composite factors for the production of every commodity; (5) a fixed real wage rate; (6) a constant money supply or the specie-flow price mechanism. Moreover, as McCulloch pointed out later, Ricardo's conclusion required two additional assumptions: that all land in cultivation was taxed, and that no raw produce was imported (see Section 7.5.2, page 160).

Ricardo assumed diminishing returns with respect to production of raw produce:

> It is only ... because land is not unlimited in quantity and uniform in quality, and because in the progress of population, land of an inferior quality, or less advantageously situated, is called into cultivation, that rent is ever paid for the use of it.
>
> (Ricardo 1951–73 [1817], vol. 1: 70)

Ricardo defined rent as the difference in productivity between lands of superior quality and the least productive land in cultivation – marginal land – where no rent was paid. The natural price of raw produce was regulated by the productivity of marginal land.

The rent of land and the natural price of raw produce would continuously increase with economic growth, because cultivation would extend to poorer quality land, and the productivity of marginal land would fall. Higher prices for raw produce would raise money wages, and consequently lower profits. Because profits were the main source of economic growth, the economy would slow down and finally reach a stationary state, unless cheaper raw produce could be freely imported from foreign countries. On the basis of the differential rent theory, Ricardo demonstrated that the interests of landlords were in conflict with the national interest.

In contrast to Smith, Ricardo assumed that capital invested in land, as well as capital in manufacturing industries, could freely move between sectors.[9] Consequently, if raw produce was taxed, farmers could increase the price of it by withdrawing their capital and reducing supply:

> If the price of raw produce did not rise so as to compensate the cultivator for the tax, he would naturally quit a trade where his profits were reduced below the general level of profits; this would occasion a diminution of supply, until the unabated demand should have produced such a rise in the price of raw produce, as to make the cultivation of it equally profitable with the investment of capital in any other trade.
>
> (Ricardo 1951–73 [1817], vol. 1: 156)

In fact, however, farmers could raise the price of raw produce without reducing its supply, because demand – for example for corn – was inelastic:

> Corn being a commodity indispensably necessary to every one, little effect will be produced on the demand for it in consequence of a tax, and therefore the supply would not probably be long excessive, even if the producers had great difficulty in removing their capitals from the land. For this reason, the price of corn will speedily be raised by taxation, and the farmer will be enabled to transfer the tax from himself to the consumer.
>
> (Ricardo 1951–73 [1817], vol. 1: 191–2)[10]

Thus, a tax on raw produce would increase its natural price without reducing capital in land.

Ricardo recognized that an increase in the natural price of raw produce would affect the natural price of other commodities: 'The probable effect of a tax on raw produce, would be to raise the price of raw produce, and of all commodities in which raw produce entered' (Ricardo 1951–73 [1817], vol. 1: 169). Moreover, Ricardo argued that 'as the value of commodities is very differently made up of raw material and labour . . . it is evident that there would be the greatest variety in the effects produced on the value of commodities, by a tax on raw produce' (Ricardo 1951–73 [1817], vol. 1: 171). Through the input–output relationship between commodities, the natural price of all commodities would change. However, Ricardo left the relationship in darkness when discussing the precise effects of various taxes. Ricardo argued as if all commodities had been produced by labour alone, or at least as if all labourers had worked with homogenous units of composite factors. In other words, Ricardo assumed the case to which his labour theory of value applied. This assumption allowed Ricardo to concentrate on the effect of a tax on the relationship between wages and profits.[11]

Because raw produce, as well as manufactured necessities, was necessary for labourers' subsistence, money wages would rise in line with the increase in the price of raw produce. If money wages had not increased, the growth of the labouring population would have diminished subject to the Malthusian adjustment. Given that demand for labour would remain the same, the price of labour would rise. In order to maintain the balance between supply and demand for labour – namely maintaining the rate of real wages – money wages had to rise.[12] Because of the reciprocal relationship between wages and profits, the uniform rate of profit would fall. The assumption of homogeneous units of composite factors indicated that relative prices of commodities would not be affected by the change in the relationship between wages and profits.

In contrast to his 1811 pamphlet, Ricardo denied that an increase in money wages because of a tax would raise the general price level. Ricardo argued:

> corn and *all* home commodities could not be materially raised in price without an influx of the precious metals; for the same quantity of money could not circulate the same quantity of commodities, at high as at low prices, and the precious metals never could be purchased with dear commodities.
>
> (Ricardo 1951–73 [1817], vol. 1: 168; emphasis in original)

Given a constant money supply, the general price level could not rise. However, later, in the third edition of the *Principles*, Ricardo indicated that the general price level could rise because of a tax, even if money supply did not increase. Ricardo explained this by relying on an increase in the velocity of money (Ricardo 1951–73 [1817], vol. 1: 213–14).

However, even if the general price level increased because of a tax, such an increase would not last long. The higher price of exports would create a trade deficit. Specie would be exported, and the general price level would fall.[13] Hence, a tax on raw produce 'could not materially interfere with foreign trade, and would not place us under any comparative disadvantage as far as regarded competition in foreign markets' (Ricardo 1951–73 [1817], vol. 1: 172).[14]

Thus, a tax on raw produce would increase its price by the amount of the tax, raise money wages, and consequently lower the rate of profit. Given a constant money supply, the general price level would not rise. Even if it rose, the specie-flow price mechanism would bring it back to the pre-tax level. The tax would ultimately fall on capitalists and consumers of raw produce.

Tithes would produce the same effect as a tax on raw produce: 'The only difference between tithes and taxes on raw produce, is, that one is a variable money tax, the other a fixed money tax' (Ricardo 1951–73 [1817], vol. 1: 176). However, because in a progressive state of society, the price of corn would rise, 'tithes would be a heavier tax than a permanent money tax' (Ricardo 1951–73 [1817], vol. 1: 177).

Taxes on manufactured necessities and manufactured luxuries would also increase their natural prices, towards which market prices would converge. However, in contrast to raw produce, an increase in the natural price of manufactures – particularly manufactured luxuries – would be accompanied with a diminution in demand for them: their supply would have to be adjusted accordingly. Consequently, it would take more time for the market price to become equal to the natural price.[15] If demand for manufactures was elastic, constant returns to scale had to be assumed in order for a tax on manufactures to raise their price exactly by the amount of the tax. In fact, Ricardo assumed constant returns with respect to production of manufactures. For example, when discussing an increase in production of manufactures because of a bounty on their exportation, Ricardo argued:

> A bounty on the exportation of manufactures will . . . raise for a time the market price of manufactures, but it will not raise their natural

> price. *The labour of 200 men will produce double the quantity of these goods that 100 could produce before*; and, consequently, when the requisite quantity of capital was employed in supplying the requisite quantity of manufactures, they would again fall to their natural price, and all advantage from a high market price would cease.
>
> (Ricardo 1951–73 [1817], vol. 1: 312–13; emphasis added)

With the assumption of constant returns, Ricardo could claim that the price of manufactured necessities would increase by the amount of the tax. The tax would also raise money wages, and lower the uniform rate of profit in all sectors, because manufactured necessities were indispensable for labourers' subsistence, and because real wages were fixed. Lower rates of profit would impede capital accumulation.

Taxes on manufactured necessities – as well as on raw produce – violated the principle of consumption reducibility. Those taxes also violated the principle of price neutrality, because the relative price of the commodity taxed would increase. Finally, they infringed the principle of distribution neutrality: they would fall exclusively on profits, while landlords and stockholders would bear the taxes only as consumers. For this reason, Ricardo thought that taxes on raw produce and manufactured necessities had to be accompanied by direct taxes on the rent of land and on dividends from bonds. If this were done, said Ricardo, 'all the objects of an income tax would be obtained' (Ricardo 1951–73 [1817], vol. 1: 161). Thus, taxes on raw produce and manufactured necessities, together with taxes on rent and dividends, could substitute for an income tax.

A tax on manufactured luxuries would not reduce profits: it would simply increase the price of the commodity taxed by the amount of the tax (Ricardo 1951–73 [1817], vol. 1: 243–4). This result assumed that luxuries were not necessary for labourers' subsistence. From the viewpoint of the principle of consumption reducibility, a tax on luxuries was desirable because it would usually be paid for out of unproductive consumption. However, Ricardo discerned the defect of such a tax: 'there is no certainty as to the amount of the tax' (Ricardo 1951–73 [1817], vol. 1: 241), because 'from taxes on expenditure a miser may escape' (Ricardo 1951–73 [1817], vol. 1: 167). With respect to certainty, Ricardo acknowledged the advantage of direct taxes. Thus, taxes on luxuries could not be a central pillar of Ricardo's taxation system.

Ricardo discussed a tax on gold as the case in which demand for the commodity taxed was elastic and production was subject to diminishing returns. Ricardo assumed that a country had gold mines, and that gold alone was used as money. With respect to the relationship between supply of money and demand for it, Ricardo stated that '[t]he demand for money is regulated entirely by its value, and its value by its quantity [i.e. supply]' (Ricardo 1951–73 [1817], vol. 1: 193). The value of money was indicated by the reciprocal number of the general price level, which was directly influenced by money supply. Thus, Ricardo thought that, given a constant volume of transactions, the money supply regulated demand for money.

A tax on gold would first reduce the profits of capital in the mines. The rate of profit would be lower than that in other sectors. Capital in mines of lower quality would be removed to other sectors in order to obtain the ordinary rate of profit. Consequently, proprietors of mines from which capital was withdrawn would lose all their rent: the rent of other proprietors would also be reduced. The money supply would diminish, and the general price level would fall. The balance of trade would become favourable to this country. However, such a trade surplus would disappear in the long run because of the specie-flow price mechanism. If this country – Ricardo supposed it to be Spain – was the only country in Europe that could produce gold, the general price level in Europe would fall because of the diminution in the circulating quantity of gold. Where was the benefit of a tax on gold to this country? Ricardo answered that it consisted of consumption goods produced by capital removed from the mines to other sectors. Thus, a tax on gold would increase national consumption, while reducing the rent of the mines and the quantity of metallic money circulating in the country and Europe.

A tax on gold was irrelevant to Britain in Ricardo's time. Britain had no great gold mines, and paper money was issued independently of the quantity of gold.[16] However, Ricardo's argument indicated how strongly he was convinced that the quantity of gold as money – as well as the quantity of paper money – had nothing to do with the opulence of a nation.

In contrast to Malthus, Ricardo did not support import duties and export bounties. They would prevent the most efficient use of capital (Ricardo 1951–73 [1817], vol. 1: 314). In particular, protective duties on the importation of raw produce would increase domestic production of raw produce. Poorer quality land would have to be taken into cultivation, and the natural price of raw produce would rise. Consequently, money wages would rise, and profits would fall: the rent of land would increase. Lower rates of profit would retard economic growth. In order to sustain economic growth as long as possible, Britain had to abolish restrictions on trade, particularly on the importation of foreign corn and raw materials. Ricardo admitted that if agriculture was subject to special taxes – for example, tithes – a countervailing duty could be imposed on foreign corn.[17] However, it would be more desirable without both special taxes on agriculture and countervailing duties. Thus, Ricardo proposed 'to acknowledge the errors which a mistaken policy has induced us to adopt, and immediately to commence gradual recurrence to the sound principles of an universally free trade' (Ricardo 1951–73 [1817], vol. 1: 317–18). To Ricardo, an opponent of the Corn Laws, customs duties were not a tax which he could recommend.

Following Smith, Ricardo argued that taxes imposed on transfers of property were taxes on capital rather than revenue, and that they would reduce funds for the maintenance of labour. Those taxes would also prevent productive capital from being distributed in the way most beneficial to the economy. Arguing that '[f]or the general prosperity, there cannot be too much facility given to the conveyance and exchange of all kinds of property' (Ricardo 1951–73 [1817], vol. 1: 154), Ricardo refused to consider all taxes on transfers of property – including inheritance taxes.

6.3.2.2 Direct taxes

Direct taxes on revenue did not violate the principle of price neutrality. No taxes on rent, profits, and wages would change the natural prices of commodities.

Ricardo argued that a tax imposed in proportion to rent would finally fall on landlords (Ricardo 1951–73 [1817], vol. 1: 173). This conclusion was identical to Smith's. However, in contrast to Smith, Ricardo derived it from the theory of differential rent. Landlords could not shift the burden of the tax to the farmers by raising their rent, because they could charge the farmers only for the difference in productivity between their lands and marginal land. A tax on rent could be said to be least harmful to capital accumulation, because it would fall only on the extravagant, namely landlords.

Ricardo thought that a tax on land could be regarded as a tax on rent if it was levied in proportion to the rent of land. However, if, as with the English tithe, a tax on land was imposed in proportion to the produce of land, it would be identical to a tax on raw produce. If, as with the English land tax, a fixed amount of money was imposed per acre of land, it would have the same effect as a tax imposed on profits in the agricultural sector.

Moreover, using numerical examples, Ricardo demonstrated that a land tax proportionate to the productivity of land, tithes, and a tax on raw produce would not change money rents but instead reduce the corn rent (namely, the money rent divided by the price of corn), and that a fixed land tax and a tax on profits in the raw produce sector would increase the money rent, but leave the corn rent intact (Ricardo 1951–73 [1817], vol. 1: 157–8, 177–8, and 211–12).[18] Thus, English landlords had no grounds to complain of the land tax (Ricardo 1951–73 [1817], vol. 1: 181).

Following Smith, Ricardo argued that a tax on housing rent would be incurred by the tenant and the landowner, although the proportion of the incidence which fell on each would be indefinite. However, in contrast to Smith, Ricardo did not think that the ground rent was a fit subject for a special tax:

> it would surely be very unjust, to tax exclusively the revenue of any particular class of a community. The burdens of the State should be borne by all in proportion to their means ... Rent often belongs to those who, after many years of toil, have realised their gains, and

> expended their fortunes in the purchase of land or houses; and it certainly would be an infringement of that principle which should ever be held sacred, the security of property, to subject it to unequal taxation.
> (Ricardo 1951–73 [1817], vol. 1: 204)

Although Ricardo's political economy indicated that the interests of landlords conflicted with the national interest, and that a tax on the rent of land would resolve such a conflict, he never accepted a special tax on rent. Such a tax would violate the security of property, as well as the principle of distribution neutrality. As will be shown in Section 7.4.1 (page 150), Ricardo did not approve of the Mills' scheme of imposing a special tax on future increases in the rent of land.

Ricardo examined David Buchanan's claim that a tax on wages would not always increase money wages (Ricardo 1951–73 [1817], vol. 1: 216–21). Suppose that the tax would be paid first by labourers, and that the wage fund – namely capitalists' demand for labour – does not change. If the tax revenue was used to employ unproductive labour, the total demand for labour – the government's and capitalists' demand for labour – would increase, and consequently money wages before tax would rise by the amount of the tax: money wages after tax would remain the same as before. However, if the tax revenue was exported as a subsidy to a foreign country, the total demand for labour would not increase. Money wages before tax would not rise. Because money wages after tax would then fall, population growth would be checked by the Malthusian mechanism.

Even if money wages before tax rose because of the increase in demand for labour, the rate of profit would decline. This would retard any accumulation of the wage fund, and consequently money wages would fall in the long run. This argument also applied to an increase in money wages because of taxes on raw produce and manufactured necessities.

Although Ricardo accepted Buchanan's claim, he indicated, as a first approximation, that a tax on wages would raise money wages by a sum equal to the tax (Ricardo 1951–73 [1817], vol. 1: 222). Thus, Ricardo defended Smith's conclusion that 'the labouring classes cannot materially contribute to the burdens of the State' (Ricardo 1951–73 [1817], vol. 1: 235). However, in contrast to Smith, Ricardo argued that a tax on wages would fall on profits – not rent. Employers of labour – namely, capitalists – had to incur the burden. Because of homogenous units of composite factors, a tax on wages would not change the relative prices of commodities.

A tax imposed equally on the profits of all industries would also maintain the relative prices of commodities. Although each capitalist would attempt to shift the burden of the tax by moving their capital to a more advantageous sector, they would fail to find one. Consequently, the tax would fall on capitalists of all industries (Ricardo 1951–73 [1817], vol. 1: 205–6). Ricardo also indicated that a tax levied on profits in any given sector had the same effect as a tax on the commodity itself. Considering that capitalists finally incurred the burden, a tax on profits in all industries and a tax on wages, as well as taxes on raw produce and manufactured necessities, were equivalent. However, a direct tax on profits had a peculiar fault: it could not be imposed 'without the inconvenience of having recourse to the obnoxious measure of prying into every man's concerns, and arming commissioners with powers repugnant to the habits and feelings of a free country' (Ricardo 1951–73 [1817], vol. 1: 161). A direct tax on profits violated the maxim of 'convenience'.

Ricardo applied his conclusions to the incidence of the poor rate:

> The poor rate is a tax which partakes of the nature of all these taxes, and under different circumstances falls on the consumer of raw produce and goods, on the profits of stock, and on the rent of land. . . . To know, then, the operation of the poor rate at any particular time, we must ascertain whether at that time it affects in an equal or unequal degree the profits of the farmer and manufacturer; and also whether the circumstances be such as to afford to the farmer the power of raising the price of raw produce.
>
> (Ricardo 1951–73 [1817], vol. 1: 257–8)

According to Ricardo, in the agricultural sector, the poor rate was imposed in proportion to the annual value of land – not the rent which farmers actually paid to the landlords. The annual value of a piece of land was calculated to include all capital which the farmer (or the landlord) had invested in the land – for example manure, fences, and irrigation canals. In contrast, manufacturers paid the poor rate according to the value of the buildings in which they worked, irrespective of the value of the machinery and other productive capital they employed. In reality, the poor rate was a tax on the profits of capital in all sectors, but imposed more heavily in the agricultural sector. The relative price of raw produce would rise by the difference in the burden of the poor rate. It would not fall on the rent of land. Money rents would increase because of a rise in the price of raw produce: hence, 'the tax may, under some circumstances, be even advantageous rather than injurious to landlords' (Ricardo 1951–73 [1817], vol. 1: 260). If this was true, landlords had no reason to complain of the poor rate, as well as the fixed land tax.[19]

Although Ricardo did not discuss a general income tax in detail, he believed that a taxation system composed of taxes on the rent of land and dividends of stock and taxes on one or more of raw produce, necessities, wages, and profits could substitute for an income tax (Ricardo 1951–73 [1817], vol. 1: 161). However, such a system did not strictly satisfy distribution neutrality, because income tax could not be paid by labourers. It would increase their relative share of income compared with the landed and capitalist classes. In contrast to a genuine income tax, Ricardo's system of income tax was not always price neutral. Only a combination of direct taxes on the rent of land, the dividends of bonds, and profits of capital escaped this flaw. However, a tax on profits would bother capitalists with inspections by a tax gatherer. Ricardo's income tax also violated the principle of consumption reducibility because it would fall on profits, and consequently retard capital accumulation.

Ricardo's main conclusions with respect to the effects and incidence of taxes can be summarized as follows: (1) a tax on raw produce (manufactured necessities) would decrease the rate of profit, raising only the price of raw produce (manufactured necessities); (2) a tax on manufactured luxuries would increase their price, but keep the rate of profit and the price of other commodities unchanged; (3) a tax levied in proportion to the rent of land would fall on rent; (4) a tax on the rent of a house would fall on the inhabitant and the landowner, although the proportion of the incidence between them would be indefinite; (5) taxes on wages and on profits would lower the rate of profit, keeping all prices unchanged.[20] Thus, in contrast to Smith's conclusion, Ricardo decided that most taxes would fall on the profits of capital – rather than the rent of land. This conclusion was produced by Ricardo's system in which rent was excluded from the determination of the price of raw produce, and any increase in the production costs of raw produce and manufactured necessities reduced the uniform rate of profit.

Taxes on raw produce, manufactured necessities, profits, and wages violated the principle of consumption reducibility, because they would reduce profits, and retard capital accumulation. Moreover, all indirect taxes would violate the principle of price neutrality, and prevent a natural allocation of resources. Only taxes on the rent of land would be harmless to capital accumulation as well as price neutral. However, a special tax on rent infringed the principle of distribution neutrality. Consequently, Ricardo's political economy could not produce any taxation system which was completely compatible with the principles of distribution neutrality, price neutrality, and consumption reducibility. This explains why Ricardo concluded that 'taxation under every form presents but a choice of evils' (Ricardo 1951–73 [1817], vol. 1: 167).

6.3.3 After the first edition of the **Principles**

Ricardo published two revised editions of his *Principles* in 1819 and 1821. Major revisions in the taxation chapters were made to his statements concerning the evil effect of taxes on capital accumulation, the relationship between taxation and the general price level, and ministers' extravagant habits (Ricardo 1951–73 [1817], vol. 1: 152, 213–14n, and 242). However, except these, there were not significant alterations. Ricardo's fundamentally negative attitude towards taxation did not change.

Ricardo held that the main practical purpose of political economy was to indicate right measures of minimizing the preventive effect of taxation on the autonomous development of private economy (Sraffa 1951–73, vol. 8: 132–3).[21] However, Ricardo himself did not put forward such measures. For example, with respect to an income tax, Ricardo only continued to ask 'whether you should not tax the profits of trade indirectly, by taxing wages, or necessaries; and other incomes directly, as rent, dividends, annuities' (Sraffa 1951–73, vol. 8: 154).[22] Ricardo did not answer this question explicitly, and became more negative about a revival of income tax. Like McCulloch, Ricardo agreed that 'an income tax is by no means a desirable tax, situated as we are, instead of the taxes now levied' (Sraffa 1951–73, vol. 8: 196).[23]

Trower – Ricardo's close friend – was eager to know what type of taxation system Ricardo favoured. After the publication of the second edition of the *Principles*, Trower suggested Ricardo make the theory of taxation more perfect and apply it to the situation in Britain (Sraffa 1951–73, vol. 8: 70).[24] Ricardo side-stepped this suggestion, answering that 'the first step must be to make the first principles of Political Economy known' (Sraffa 1951–73, vol. 8: 79).[25] Trower did not give up. When Ricardo wrote an article on the funding system, Trower tried to persuade him to explain first of all 'how, in the event of diminished revenue, or of [i]ncreased expences, can we raise the funds necessary for our *current expenditure*?' (Sraffa 1951–73, vol. 8: 110; emphasis in original).[26] This time, Ricardo answered:

> The subject you mention is very important to be well analysed, and explained – namely, the best means of raising the funds which may be necessary for future expenditure. . . . The difficulty which encompasses it is almost sufficient to deter one from entering upon it. . . . [O]n some future day, I will bend my whole mind to the consideration of this subject.
>
> (Sraffa 1951–73, vol. 8: 132)[27]

However, this promise was not carried out. Finally, after the publication of the third edition of the *Principles*, Trower requested Ricardo construct a real taxation system derived from his system of political economy (Sraffa 1951–73, vol. 9: 69).[28] To this request, Ricardo's answer was that 'I, as well as you, would like to see an application of the Principles of Political Economy, as now understood, to the practical operation of taxation, and I hope it will not be long before such a work appears' (Sraffa 1951–73, vol. 9: 87).[29] However, this answer did not mean that Ricardo himself would write 'such a work'. Ricardo wrote, 'you make a great mistake in supposing me capable of producing so important a work' (Sraffa 1951–73, vol. 9: 88).

In fact, Ricardo produced no new taxation system for Britain. His attitude towards all taxes was simply negative. In Parliament '[a]s to particular taxes, it was unnecessary to [Ricardo] to state his sentiments, seeing he was an enemy to taxation altogether' (Sraffa 1951–73, vol. 5: 26). In 1822, Ricardo voted for every proposal of tax reduction, sweeping away the misunderstanding that he was an advocate of taxation (Sraffa 1951–73, vol. 5: 154).

Thus, Ricardo avoided a positive declaration of his opinions about a fair and efficient system of taxation, confining himself to demonstrating abstract principles of taxation deduced from his system of political economy. However, there was an exception. After the publication of the second edition of the *Principles*, Ricardo wrote an article for the *Encyclopaedia Britannica* entitled 'Funding system'. In the article, Ricardo proposed a capital levy – a lump-sum tax on property – in order to redeem the outstanding public debt. In fact, the capital levy scheme suggests that Ricardo had definite views on debt management. Let us now examine why Ricardo recommended a capital levy.

6.4 Public debt, the sinking fund, and a capital levy

6.4.1 Before 1819

Ricardo's earliest reference to public debt was made in his 'Notes on Bentham's *Sur les Prix*' (1810–11). Ricardo criticized Bentham's argument that a reduction of public debt would increase productive capital transforming taxpayers' consumption into public creditors' savings.[30] Ricardo commented:

> The capital liberated by the sinking fund is not a creation of capital, – it is merely a transfer from the pockets of those who pay the necessary tax to create that fund, to the public creditor. . . . The same effects would have followed if there had been no sinking fund, and the contributors had accumulated their portions of the tax into Capital.
>
> (Ricardo 1951–73 [1810–11], vol. 3: 272–3)

Thus, Ricardo did not accept that a reduction of public debt would increase productive capital. However, later Ricardo had to rely on this same reasoning to demonstrate that redemption of public debt would be indispensable to national prosperity.

In his *Essay on Profits* (1815), Ricardo acknowledged that a fall in prices because of free importation of corn would benefit stockholders at the cost of landlords, who would receive less rent. However, Ricardo defended this benefit to stockholders, arguing that because the price of their stock had fallen and other prices had increased during the war, 'they have been by far the greatest sufferers by the war' (Ricardo 1951–73 [1815], vol. 4: 40).[31]

Ricardo did not accept McCulloch's early proposal for the reduction of the interest on public debt in proportion to the fall in the price of corn since the debt had been contracted during the Napoleonic War. On 9 June 1816, Ricardo wrote to McCulloch:

> I cannot ... agree with you in the necessity of adopting the violent remedy you propose for our present difficulties, of reducing the interest on the National Debt, because though such a measure might be beneficial to one class at the expence of another, it would afford very little relief to the country, and would be a precedent of a most alarming and dangerous one.
>
> (Sraffa 1951–73, vol. 7: 37)[32]

Ricardo thought that a forced reduction of the interest on public debt would finally induce the government to commit the greatest injustice, namely a voluntary default. To pay constant interest on public debt and regularly to redeem the principal by means of the sinking fund were ‘a positive bargain between the nation and the stockholder, which cannot be infringed by one of the contracting parties’ (Sraffa 1951–73, vol. 7: 106).[33]

In fact, however, public debt was not regularly redeemed by the sinking fund. It was often used by the government to make up a budget deficit or issue new public debt. Stockholders suffered in such cases because a fall in the price of public debt resulted. What was arguably even worse was that such measures constituted a breach of contract on the part of the government and a step towards a voluntary default. Ricardo was critical of the government’s unjust operation of the sinking fund, as well as the unreasonable public prejudice against stockholders. In a letter to Trower on 25 December 1815, Ricardo wrote: ‘I am every day becoming a greater enemy to the funding system’ (Sraffa 1951–73, vol. 6: 345).

In *Proposal for an Economical and Secure Currency* (1816), Ricardo criticized the Bank of England for making huge profits from exclusive privileges given by the government. The charge for the management of the public debt – as well as the issues of inconvertible bank notes and investment of government deposits – produced unreasonable profits for the Bank of England. Such monopolistic profits were paid for by taxes on the public. To Ricardo, it was ‘lamentable to view a great and opulent body like the Bank of England, exhibiting a wish to augment their hoards by undue gains wrested from the hands of an overburthened people’ (Ricardo 1951–73 [1816], vol. 4: 93). Ricardo thought that the Bank of England should ‘relinquish to the state, the whole benefit which is derived from the employment of eleven million of the public money’ (Ricardo 1951–73 [1816], vol. 4: 93). However, the government, as well as the Bank of England, would not accept such a proposal. Thus, Ricardo proposed that the public debt had to be paid off in order to end the unjust profits of the Bank of England.

Ricardo’s *Principles* did not have a separate chapter on public debt. Ricardo discussed the subject briefly in the chapter on ‘Taxes on Other

Commodities than Raw Produce'. Although Ricardo regarded unproductive government expenditure financed by public debt as harmful to economic growth, he accepted the argument that payment of the interest on public debt was a mere transfer from the taxpayers to the stockholders. The government had neither the right nor the ability to decide who would have used the amount paid as interest more productively, the taxpayer or the stockholder. Ricardo argued:

> it is error and delusion to suppose, that a real national difficulty can be removed, by shifting it from the shoulders of one class of the community, who justly ought to bear it, to the shoulders of another class, who, upon every principle of equity, ought to bear no more than their share.
>
> (Ricardo 1951–73 [1817], vol. 1: 246)

A reduction of the interest on public debt – or a default – would probably produce no advantageous macroeconomic effect. Moreover, it was an obvious infringement of justice and good faith, to which Ricardo attached more importance than wealth.[34] However, Ricardo's claim that reduction of interest payments had no advantageous effect on wealth has been misinterpreted by some modern macroeconomists as showing that he thought that public debt would produce the same macroeconomic effect as a lump-sum tax.[35] Those who refer to 'the Ricardian equivalence theorem' should have taken more seriously Ricardo's statement:

> From what I have said, it must not be inferred that I consider the system of borrowing as the best calculated to defray the extraordinary expenses of the State. It is a system which tends to make us less thrifty – to blind us to our real situation.
>
> (Ricardo 1951–73 [1817], vol. 1: 247)

According to Ricardo, the people could not appreciate that a public debt was the same as a tax of an equal amount. They would save less than they would have in the case of taxation, regarding the public debt as their net asset. In fact, however, it would produce no net revenue for them: they would receive only what they paid. Thus, public debt would retard capital accumulation in the country by creating the illusion of an asset.

A decline in capital accumulation because of public debt would diminish the taxable capacity of the nation. Heavier taxes would have to be imposed in order to finance growing government expenditure. Because almost all taxes would fall on profits, capital would be exported in order to avoid heavy taxes. Consequently the taxable capacity would further diminish. Such a vicious circle would finally produce national bankruptcy. Ricardo wrote:

> If, on the breaking out of any future war, we shall not have very considerably reduced our debt, one of two things must happen, either the whole expenses of that war must be defrayed by taxes raised from year to year, or we must, at the end of that war, if not before, submit to a national bankruptcy.
>
> (Ricardo 1951–73 [1817], vol. 1: 249)

In contrast to Hume, Ricardo never accepted voluntary bankruptcy was a good policy: 'during peace, our unceasing efforts should be directed towards paying off that part of the debt which has been contracted during war' (Ricardo 1951–73 [1817], vol. 1: 248).

Although the public debt had to be extinguished as soon as possible in order to prevent the economy from declining, this should not be accomplished by reducing the interest or suspending payments. Public debt could be redeemed faithfully by the sinking fund, if the fund was derived from a true budget surplus. However, this was not the case in Britain. Thus, Ricardo proposed:

> A country which has involved itself in the difficulties attending this artificial system, would act wisely by ransoming itself from them, at the sacrifice of any portion of its property which might be necessary to redeem its debt. That which is wise in an individual, is wise also in a nation.
>
> (Ricardo 1951–73 [1817], vol. 1: 248)

This was Ricardo's first explicit proposal of a capital levy as a means to redeem public debt.

6.4.2 'Funding system' (1820)

Early in September, 1819, Macvey Napier – the editor of *Encyclopaedia Britannica* – asked Ricardo to write an article on the 'Funding system'. James Mill also recommended Ricardo write the article. Although Ricardo replied that 'I am sure that with my best efforts it would not be deserving of a place in the company by which it would be surrounded' (Sraffa 1951–73, vol. 8: 55),[36] he finished the first draft by the end of September.[37] Ricardo was dissatisfied with the article, writing to Mill that 'the best way of disposing of it is to put it in the fire' (Sraffa 1951–73, vol. 8: 76).[38]

Ricardo disliked his 'Funding system', because he thought that it added very few original observations to Robert Hamilton's *Inquiry Concerning the Rise and Progress, the Redemption and Present State, and the Management of the National Debt of Great Britain and Ireland* (third edition, 1818). This book revealed the flaws of the fixed-transfer system, as well as of Richard Price's argument that public debt could be redeemed by an automatic increase in the sinking fund at compound interest.[39] Ricardo's article was filled with quotations from Hamilton's book. Ricardo wrote that '[t]he only point of difference between Dr. H[amilton] and me is this, – he would I believe support the Sinking Fund, I would get rid of it entirely' (Sraffa 1951–73, vol. 8: 78).[40] One feature of his article Ricardo did believe was original was the capital levy scheme. In fact, however, the capital levy scheme did not originate with Ricardo. It had been proposed by Archibald Hutcheson in 1721, and rejected by Hume because of its unfeasibility and inequality (see Section 1.1, page 2). As will be shown below, Ricardo could not solve the problems raised by Hume.

The first part of 'Funding system' described the history of the sinking fund in Britain. A redemption of public debt through a true sinking fund would increase the amount of productive capital in the country, because the stockholders would save and invest money repaid from taxpayers' consumption: here Ricardo adopted Bentham's argument which he had rejected in his 1810–11 notes. The increase in productive capital would promote economic growth: Say's law guaranteed that no general gluts would occur as a result. A higher rate of growth would bring the time forward when the economy would reach a stationary state because of diminishing returns in the agricultural sector. However, this could be avoided by freely importing foreign corn at a cheaper price. Consequently, public debt could be reduced without a decline in economic growth. When the public debt was cleared, taxes – imposed for the purpose of paying the interest on the debt and its principal – would be removed, and the people could consume more than before. Thus, Ricardo argued that 'a sinking fund, honestly applied, is favourable to the accumulation of wealth' (Ricardo 1951–73 [1820], vol. 4: 184).

In fact, however, the British Parliament had permitted the government to divert the sinking fund into interest payments on the existing debt, and re-mortgage it. Consequently, contrary to its original purpose, the fund increased public debt. Such an increase in public debt was not only disadvantageous in the accumulation of national wealth, but also a breach of faith with stockholders and taxpayers. In order to prevent the sinking fund from becoming 'instruments of mischief and delusion' (Ricardo 1951–73 [1820], vol. 4: 157), Parliament had to be reformed. Following Bentham and James Mill, Ricardo proposed several ideas for parliamentary reform – such as the secret ballot and an extension of the suffrage – so that it 'moved in more direct sympathy with the people' (Sraffa 1951–73, vol. 5: 269).[41] However, it would take a long time to accomplish parliamentary reform, while public debt would continue to be accumulated by ministers abusing the sinking fund. Thus, Ricardo thought that 'it would be a great improvement in our system for ever to get rid of the practice of funding' (Ricardo 1951–73 [1820], vol. 4: 190), and that public debt should be redeemed immediately by a capital levy.

The capital levy scheme was discussed in the second part of the article. Ricardo listed three ways to finance a war: a war tax; a perpetual debt; and a debt with a sinking fund, that is 'to provide, by taxes, a fund, in addition to the interest, which, accumulating at compound interest, should finally be equal to the debt' (Ricardo 1951–73 [1820], vol. 4: 186). Ricardo accepted that '[i]n point of economy, there is no real difference in either of the modes' (Ricardo 1951–73 [1820], vol. 4: 186). In fact, however, a perpetual debt would retard capital accumulation, because it would create the popular illusion of an asset. A debt with a sinking fund would partly avoid this fault, if the debt was regularly reduced by the fund. However, if the fund was diverted into a mortgage on a new debt, the amount of outstanding debt would increase. Consequently, a debt with a sinking fund would be more harmful to capital accumulation than a perpetual debt. As the first part of the article indicated, this had been the case in Britain. In contrast, a one-time war tax would neither produce the illusion of an asset, nor be used for other purposes than war. Thus, 'the preference should be given to the first' (Ricardo 1951–73 [1820], vol. 4: 186). On this basis, Ricardo chose a capital levy as the best means of redeeming the public debt.

However, a capital levy had a problem: it would violate the principle of distribution neutrality. Because it would not fall on wages, salaries, and professional incomes, people who lived on these incomes would benefit from the sacrifices of capitalists and landlords. Ricardo attempted to solve this problem by arguing for the free movement of labour between occupations:

> We believe that [those who live on wages, salaries, and professional incomes] would be very little, if at all benefited by the system of war-taxes. Fees to professional men, salaries, and wages, are regulated by the prices of commodities, and by the relative situation of those who pay, and of those who receive them. A tax of the nature proposed, if it did not disturb prices, would, however, change the relation between these classes, and a new arrangement of fees, salaries, and wages, would take place, so that the usual level would be restored.
>
> (Ricardo 1951–73 [1820], vol. 4; 188–9)

According to Ricardo, although in the short run a capital levy would benefit people living on wages, salaries, and professional incomes, in the long run it would produce the same distributive effect as a general income tax. However, this solution undermined Ricardo's own claim that no tax should be imposed on a specific kind of revenue. For any tax on a specific occupation could be justified as an equal tax, on the basis of a free movement of labour between occupations. Moreover, Ricardo ignored the difference in creditworthiness between the government and people who would have to borrow money in order to pay a capital levy. The rate of interest on a private borrowing would usually be higher than that on government borrowing. Consequently, the total amount of interest payments would increase because of a capital levy. Thus, Ricardo's capital levy scheme did not solve the problem of inequality which Hume identified in Hutcheson's proposal.

6.4.3 Ricardo in Parliament

Before publishing 'Funding system', Ricardo had entered Parliament in 1819. His speeches on public debt were based on the arguments which he developed in the article. On 6 September 1819, Ricardo referred to a capital levy for the first time in Parliament. Criticizing the government for having diverted the sinking fund to the payment of interest on existing and new public debts, Ricardo insisted on reducing and abolishing the fund. As an alternative way to redeem public debt, Ricardo proposed a tax on all kinds of capital in earnest on 16 December. Members of Parliament regarded the capital levy scheme as 'a wild sort of notion' (Sraffa 1951–73, vol. 8: 147). Because of the scheme, Ricardo lost his previous reputation gained as an originator of the currency plan embodied in Peel's Bill of 1819, and came to be looked upon as a theorist (Sraffa 1951–73, vol. 5: xix–xx). Ricardo anticipated that his scheme would not be accepted by the public. Ricardo wrote to Napier on 11 May 1820, 'I fear that no plan for paying off the debt will receive any countenance from Parliament. Men do not like to make an immediate sacrifice for a future good' (Sraffa 1951–73, vol. 8: 187). Despite his lack of hope, Ricardo put forward the scheme consistently and openly in Parliament.

Ricardo's explanation, that a capital levy was distribution neutral in the long run, was not accepted in Parliament. For example, Henry Brougham – one of Ricardo's friends in Parliament – commented:

> [Ricardo's] views were, often, indeed, abundantly theoretical, sometimes too refined for his audience, occasionally extravagant from his propensity to follow a right principle into all its consequences, without duly taking into account in practice the condition of things to which he was applying it, as if a mechanician were to construct an engine without taking into consideration the resistance of the air in which it was to work, or the strength and the weight and the friction of the parts of which it was to be made.
>
> (Sraffa 1951–73, vol. 5: xxxiii)

The landed interest regarded Ricardo's scheme as a proposal to transfer their land to the stockholders, whereas the moneyed interest complained that their public debt would be bought back at a market price lower than its face value.[42] Ricardo repeated that his scheme was to impose a temporary tax on not only land but also on all other property, although he acknowledged that some landlords would have to sell or mortgage their land to stockholders. Ricardo also did not think it unjust for the government to buy public debt at a market price lower than face value, because stockholders had also bought them at a market price. However, Members of Parliament did not take his proposal and explanation seriously. In a letter to Trower on 28 December 1819, Ricardo wrote:

> The most serious obstacle which I see against the adoption of the plan is the state of the representation of the House of Commons, which is such as to afford us no security that if we got rid of the present debt, we should not be plunged into another.
>
> (Sraffa 1951–73, vol. 8: 148)

After the publication of 'Funding system', Ricardo continued to propose Parliament redeem the existing public debt by a capital levy – not the sinking fund. Ricardo believed that it was his duty. He wrote to Trower in March 1822, 'I should be neglecting my duty if with my opinions of the Sinking Fund I did not do every thing in my power to get rid of it' (Sraffa 1951–73, vol. 9: 180).

Because his scheme was not accepted, Ricardo supported every proposal that would reduce the sinking fund and public debt. For example, Ricardo approved any tax reduction within the real balance of the sinking fund. Ricardo acknowledged as practical John Maberly's scheme to reduce the debt by a lump-sum payment out of the land tax. Ricardo also supported Henry Parnell's plan to apply the sinking fund to replacing perpetual annuities with limited annuities, arguing that 'by taking the sinking fund out of the hands of ministers, Parnell's plan would do away his great objection to it' (Sraffa 1951–73, vol. 5: 270).

However, to Ricardo, these schemes were only second-best. Ricardo never gave up the best policy, a capital levy, to the end of his life. For example, to Pascoe Grenfell's statement that Ricardo's crotchet of a capital levy was the wildest of all plans, Ricardo replied that he did not think it so Utopian a scheme as imagined. To Ricardo, a capital levy scheme 'would merely carry further the principle of income tax' (Sraffa 1951–73, vol. 5: 271).

6.5 Conclusion

Because he attached great importance to the free economic activity of individuals, Ricardo had a negative opinion of government expenditure. Believing that in most cases government expenditure would prevent capital accumulation, Ricardo insisted on minimizing government expenditure. Ricardo also emphasized that, given a certain level of government expenditure, knowledge of political economy had to be used to determine the least harmful means of finance.

However, Ricardo's political economy – founded on the theory of differential rent and the labour theory of value – demonstrated that no taxation system was completely compatible with both the principles of distribution neutrality, price neutrality, and consumption reducibility, and the maxims of certainty and convenience. In particular, Ricardo's theory of tax incidence indicated that most taxes would fall on the profits of capital: this meant that capital accumulation would usually be prevented by taxation. The following text reveals Ricardo's fundamental view of taxation:

> Notwithstanding the immense expenditure of the English government during the last twenty years, there can be little doubt but that the increased production on the part of the people has more than compensated for it. The national capital has not merely been unimpaired, it has been greatly increased[.] . . . Still, however, it is certain that but for taxation this increase of capital would have been much greater. There are no taxes which have not a tendency to lessen the power to accumulate. . . . Some taxes will produce these effects in a much greater degree than others; but the great evil of taxation is to be found, not so much in any selection of its objects, as in the general amount of its effects taken collectively.
>
> (Ricardo 1951–73 [1817], vol. 1: 151–2)

Because most taxes would prevent capital accumulation, and no taxes could simultaneously satisfy all his criteria, Ricardo did not make public his overall plan of a fair and efficient system of taxation.

Although Ricardo held a generally negative view of taxation, he proposed a capital levy in order to redeem the outstanding public debt. Relying on a rather outrageous explanation of the short run and the long run, Ricardo claimed that the tax would be distribution neutral. The capital levy would also be price neutral and the amount of revenue from it would be certain if the total amount of capital could be assessed precisely. However, assessment of capital would bother the owners. Moreover, because the tax would fall on the profits of productive capital, it would damage capital accumulation. Despite these faults with a capital levy, Ricardo proposed it.

According to Ricardo, public debt produced the popular illusion of an asset, monopolistic profits for the Bank of England, unreasonable public prejudice against stockholders, and unjust schemes of interest reduction. Public debt would not only impede the growth of national wealth, but also infringe justice and good faith. In order to eliminate these evils, the existing public debt had to be paid off as immediately as possible.

To Ricardo, the sinking fund would have been equivalent in principle to a capital levy, if the fund had been financed by a true budget surplus, and used for its original purpose. In fact, however, the British government often maintained the fund by borrowing, and mortgaged it for new public debt. Consequently, the sinking fund increased – rather than reduced – the volume of public debt. A continuous increase in public debt would prevent capital accumulation, and finally produce national bankruptcy. For this reason, Ricardo proposed a capital levy as the best method of debt management.

However, Ricardo proposed a capital levy only as a one-time war tax. It was only better than continuous heavy taxes and national bankruptcy. Ricardo's advocacy of the capital levy scheme did not contradict his fundamental opinion that no tax could be positively recommended as a perpetual system of taxation.

Neither Ricardo's fundamental opinion of taxation nor his capital levy scheme were practical. In contrast to Smith, Ricardo did not put forward realistic – or concessionary – policies of public finance. Ricardo did not believe that he had the ability to do so. What Ricardo achieved in his arguments was to prove rather abstractly that taxation and public debt equated to a 'national evil' or 'political diseconomy' caused by any government in liberal and commercial society. If this is true, the title of Ricardo's *Principles* can be changed to *Principles of Political Economy, and Diseconomy*.

Notes

1 This chapter partly draws on Dome (1992 and 2000).

2 Ricardo's theory of taxation has been referred to, for example, in Whewell (1968 [1829 and 1831]), Marshall (1959 [1920]: 686–9), Blaug (1958: 195), Musgrave (1959: 385–92), Shoup (1960), O'Brien (1975: 240–71), Hollander (1979: 288–9 and 381–93), Eagly (1983), De Vivo (1987: 195–6), and Tullio (1989). However, there is no agreement about what system of taxation Ricardo thought most desirable. For example, Shoup (1960: 224) leaves Ricardo's indeterminate attitude towards an income tax as 'a subject for further study'.

3 Ricardo's capital levy has been examined, for example by Roberts (1942), Shoup (1960: 160–5), Anderson and Tollison (1986), Asso and Barucci (1988), Visaggio (1989), and Churchman (2001).

4 Fetter (1969: 73) argues that 'Ricardo's belief that self-interest was the wellspring of economic development also went beyond Smith in Ricardo's almost pathological feeling that the government did everything badly'. Hutchison (1978: 51) states that Ricardo 'is not merely the *only*, but outstandingly the *most*, thoroughgoing advocate of *laissez-faire* among the major British economists' (emphasis in original). Churchman (2001: 54–7) argues that although Ricardo acknowledged the government's role in providing social infrastructure, 'Ricardo's views on the economic role for government appear at times to be impossibly narrow'. According to Churchman (2001: 68–9), Ricardo stubbornly rejected Malthus's arguments about the role of government in stimulating effectual demand, because Ricardo thought that they would lead to an explicit acceptance of public extravagance.

5 For Ricardo's negative view of government expenditure in his last years see, for example, Sraffa (1951–73, vol. 4: 356 and vol. 9: 276).

6 Ricardo concluded: 'If this view of the effect of taxation be correct, it will follow that Mr. Bosanquet's estimate, that 48 millions has been actually added to the prices of commodities in consequence of taxation since the year 1793, and that such addition will sufficiently account for the rise in the prices of commodities, without having recourse to the depreciation of the circulating medium as the cause, is a false theory, neither supported by reason nor

probability' (Ricardo 1951–73 [1811], vol. 3: 242). However, Ricardo acknowledged that a tax on corn would raise the general price level by raising money wages, and that such a rise would not require an increase in the money supply. Although this view was rejected in the first edition of *Principles*, it was revived in the third edition. This issue will be discussed more precisely in Section 6.3.2.1 (page 123).

7 Shoup (1960: 249) shows that Ricardo's interest lay in the economic consequences of taxes with respect to prices, capital accumulation, and distribution of income.

8 Shoup (1960: 220–3) gives three possible reasons why Ricardo rarely referred to the income tax: (1) Ricardo viewed it as a direct tax on profits; (2) Ricardo was only interested in an abstract analysis of taxation; (3) Ricardo fundamentally disliked the method of collecting income tax. However, none of these interpretations gives a decisive answer.

9 Ricardo recognized that practically these were not always the case: 'the capital which [the farmer] has expended may be so incorporated with the land, that it cannot be removed from it' (Ricardo 1951–73 [1817], vol. 1: 261).

10 In Appendix L of his *Principles of Economics*, entitled 'Ricardo's Doctrine as to Taxes and Improvements in Agriculture', Alfred Marshall criticized Ricardo's assumption of zero elasticity of demand for corn: 'the assumption that the demand for produce is absolutely inelastic is a very violent one. The rise in price would in fact be sure to cause an immediate falling-off in the demand for some kinds of produce, if not for the staple cereals: and therefore the value of Corn, *i.e.* produce in general, would never rise in full proportion to the tax, and less capital and labour would be applied in the cultivation of all lands. There would thus be a diminution in the Corn surplus from all lands' (Marshall 1959 [1920]: 686–7).

11 Eagly (1983), Dome (1992), and Erreygers (1995) reconstruct Ricardo's theory of tax incidence on the basis of the input–output relationship between commodities.

12 With respect to Ricardo's decision to base his theory of taxation on the constant real-wage rate, Hollander (1979: 310) argues that 'the constancy of the wage rate is nothing more than a first approximation, for purposes of analytical simplicity, to be relaxed when appropriate'.

13 Ricardo also indicated that 'if [precious metals] were not exported, if by prohibitory laws they could be retained in a country, the effect on the exchange rule would counterbalance the effect of high prices' (Ricardo 1951–73 [1817], vol. 1: 232).

14 Hollander (1979: 249–50) explains the change in Ricardo's opinion on the relationship between a tax and the general price level by the argument that: 'what was a *hypothetical* (temporary) rise in prices in consequence of taxation in the first two editions [of the *Principles*] became an *actual* rise in the third, the consequence of which, however, is an outflow of money and a reversion of prices to their original level. That taxation leaves the price level unchanged in a comparison of *equilibrium* positions was Ricardo's consistently held position, and it was on quantity theory grounds that he made his case' (emphasis in original).

15 Ricardo argued: 'the duration of the interval, before the market price will conform to the natural price, must depend on the nature of the commodity, and on the facility with which it can be reduced in quantity' (Ricardo 1951–73 [1817], vol. 1: 191).

16 Ricardo recognized qualification to his argument: 'The argument which I have just been using, applies only to those states of society in which the precious metals are used for money, and where paper credit is not established' (Ricardo 1951–73 [1817], vol. 1: 193).

17 Ricardo argued: 'Tithes . . . may be considered as injurious to landlords, inasmuch as they act as a bounty on importation, by taxing the growth of home corn, while the importation of foreign corn remains unfettered. And if, in order to relieve the landlords from the effects of the diminished demand for land, which such a bounty must encourage, imported corn were also taxed one tenth, and the produce paid to the State, no measure could be more fair and equitable' (Ricardo 1951–73 [1817], vol. 1: 179).

18 For a mathematical analysis of the numerical examples, see Dome (1992: 50–2).

19 Ricardo's conclusion of the poor rate depended on the assumption that agricultural capital could be easily transferred to more advantageous sectors. If agricultural capital could not be withdrawn – and unless demand for corn was inelastic – the price of raw produce would not rise. In this case, Smith's conclusion held true. Ricardo argued: 'in a stationary, or in a retrograde country, so far as capital could not be withdrawn from the land, if a further rate were levied for the support of the poor, that part of it which fell on agriculture would be paid, during the current leases, by the farmers; but, at the expiration of those leases, it would almost wholly fall on the landlords' (Ricardo 1951–73 [1817], vol. 1: 260–1).

20 Smith differed from Ricardo with respect to conclusions (1) and (5). Smith argued that a tax on raw produce would reduce rents, keeping the prices of manufactured necessities and manufactured luxuries unaltered, and that taxes on manufactured necessities, on wages, and on profits would reduce rents, raising the prices of manufactured necessities and manufactured luxuries. See Section 3.3.2, page 55.

21 Ricardo's letter to Trower on 12 November 1819.

22 Ricardo to Trower, 28 January 1820.

23 Ricardo to McCulloch, 13 June 1820.

24 Trower to Ricardo, 19 September 1819.

25 Ricardo to Trower, 25 September 1819.

26 Trower to Ricardo, 26 October 1819.

27 Ricardo to Trower, 12 November 1819.

28 Trower to Ricardo, 13 September 1821.

29 Ricardo to Trower, 4 October 1821.

30 For Bentham on the effects of the sinking fund, see Section 4.3.3, page 82.

31 Ricardo repeated his defence of stockholders in the *Principles*, arguing that the general price level did not fall in proportion to the diminution in the price of corn, and that landlords' and industrious men's losses from an increase in the real burden of taxes would at least partly be compensated for by an increase in their real purchasing power. The balance between the loss and benefit would depend on the proportion taxes bore to the annual revenue. See Ricardo (1951–73 [1817], vol. 1: 423n).

32 For McCulloch's abandonment of the interest reduction scheme, see Section 7.6, pages 165–6.

33 Ricardo's letter to McCulloch on 4 December 1816.

34 Ricardo argued: 'the claims of justice and good faith, a greater utility, are not to be compelled to yield to those of a less. . . . Justice and good faith demand that the interest of the national debt should continue to be paid, and that those who have advanced their capitals for the general benefit, should not be required to forego their equitable claims, on the plea of expediency' (Ricardo 1951–73 [1817], vol. 1: 245–6).

35 The macroeconomic equivalence of public debt and taxation was discussed first by Barro (1974). Barro did not use the term 'Ricardian' because he did not know that Ricardo had referred to such an equivalence. It was Buchanan (1976) who invented the term 'the Ricardian equivalence theorem'.

36 Ricardo to Mill, 6 September 1819.

37 Asso and Barucci (1988: 61–2) reproduce Ricardo's manuscript which is estimated to have been written late in 1819 or early in 1820. In the manuscript, Ricardo put forward a concrete plan for carrying out a capital levy: a 25 per cent tax rate and a 5-year payment period. Ricardo also stated that the government should issue Exchequer Notes in order to prevent the circulating medium from being insufficient for tax payments. However, Ricardo did not publish this plan.

38 Ricardo to Mill, 23 September 1819.

39 Two chapters in Part 3 of Hamilton's book – Chapter 2, 'Examination of Dr. Price's Views of Finance', and Chapter 3, 'Examination of Mr. Pitt's Sinking Fund' – are reproduced in O'Brien (1999, vol. 3: 157–92).

40 Ricardo's letter to Trower, 25 September 1819.

41 For Ricardo's ideas for parliamentary reform see, for example, Sraffa (1951–73, vol. 5: 495–512).

42 In his letter to Trower on 28 December 1819, Ricardo wrote: 'A great deal more has been said than I intended there should be of an incidental observation of mine respecting the payment of the debt, as it usually happens I am attacked by the most opposite parties' (Sraffa 1951–73, vol. 8: 147).

7 John Ramsay McCulloch

7.1 Introduction

John Ramsay McCulloch's review of Ricardo's *Principles of Political Economy, and Taxation* praised the book wholeheartedly: 'Mr Ricardo has examined the fundamental principles on which the science of Political Economy rests, and . . . he has done more for its improvement than any other writer, with perhaps the single exception of Dr Smith' (McCulloch 1818: 60). McCulloch believed that Ricardo had founded a new political economy on the theory of differential rent and the labour theory of value, and that these theories enabled Ricardo to demonstrate the incidence and effects of taxes more precisely than Smith.[1]

However, after Ricardo's death, McCulloch gradually became critical of Ricardian political economy, particularly with respect to its deductive method and its conclusions about class conflict. In the first edition of *Principles of Political Economy* (1825; henceforth *Principles*), McCulloch indicated the type of political economy at which he aimed:

> By a patient induction – by carefully observing the circumstances attending the operation of particular principles, [a political economist] discovers the effects of which they are really productive, and how far they are liable to be modified by the operation of other principles. It is thus that the relation between rent and profit – between profit and wages, and the various general laws which regulate and connect the apparently conflicting, but really harmonious interests of every different order in society, have been discovered, and established with all the certainty of demonstrative evidence.
>
> (McCulloch 1825b: 60)

To McCulloch, the principles of political economy always had to be applied to and tested by real circumstances.[2] The conclusion which McCulloch derived from the testing and modification of Ricardian principles was that the interests of different classes of society were harmonious, rather than conflicting.

In 1831, McCulloch criticized Ricardian political economy more fully, indicating that he was no longer a simple expositor of the doctrine:

> Though we highly prize the talents of Mr Ricardo, and have endeavoured, on all occasions, to do justice to his merits, we are not insensible to his defects; and to suppose, as some appear to do, that his work has fixed and ascertained every principle of the science, and that economists have nothing left but to comment upon and explain it, is altogether absurd. In treating of rent, Mr Ricardo doubtless made discoveries; and has exhibited some beautiful specimens of profound and luminous investigation. Still, however, it is not to be denied that this part of his work is infected with grave errors.
>
> (McCulloch 1831: 97)

McCulloch criticized Ricardo's argument that improvement of land would worsen the condition of the landlords by lowering the price of raw produce and reducing the rent of the land, whereas such improvement would ameliorate the condition of other classes. McCulloch demonstrated that, practically, improvement of land was not introduced so rapidly as to lower the price of raw produce, and that if the price of raw produce fell, the rent of land would not diminish, because an increase in population (hence demand for raw produce) would bring new land into cultivation. Consequently, the interest of the landlord did not contradict that of the public. Through his five editions of the *Principles* (1825, 1830, 1843, 1849, and 1864), McCulloch rejected the idea of an inherent conflict not only between landlords and other classes, but also between capitalists and labourers, and between manufacturers and agriculturalists.

McCulloch's *Principles* did not have chapters on taxation and public debt. However, McCulloch wrote three editions of *Treatise on the Principles and Practical Influence of Taxation and the Funding System* (1845, 1852, and 1863; henceforth *Treatise on Taxation*), as supplementary volumes to the *Principles*.[3] Besides this main work, McCulloch devoted a number of writings throughout his life to the issue of public finance. For example, McCulloch wrote two essays on the reduction of the interest on public debt (1816); the articles in the *Scotsman* (1817–27) and the *Edinburgh Review* (1818–37); and the articles on 'Taxation' in the three editions of the *Encyclopaedia Britannica* (1824, 1842, and 1860). These were based on ample data regarding taxes and public debts, as well as on a wide-ranging modification of Ricardian political economy. Thus, McCulloch realized his wish indicated in the Ricardo Memorial Lectures:

> That part of Mr Ricardo's work, in which he applies his principles to discover the real incidence and effect of taxes on rent, profit, wages, and raw produce . . . must always be a subject of careful study to those

> who wish to render themselves thoroughly acquainted with this great department of economical science.
>
> (McCulloch 1995 [1824c]: 70)

In this chapter, I will examine McCulloch's arguments concerning government expenditure, the principles of taxation, direct taxes, indirect taxes, and public debt, demonstrating that he modified Ricardian propositions about class conflict in his writings on public finance, as well as on political economy.[4]

7.2 Government expenditure

In the final chapter of the second edition of the *Principles*, McCulloch emphasized the importance of frugality by governments – as well as individuals – for continuous growth of national wealth. In the following passage, McCulloch claimed that disastrous effects would be likely to follow from increasing taxation:

> Were the principle admitted, that government might raise money, not for the protection and good government of the state, but in order to excite industry and ingenuity by the pressure of taxation, or the luxury of public functionaries, an avenue would be opened to every species of malversation. It is, indeed, pretty certain that no people would submit to be taxed for such purposes; but if they did, the flagrant abuses to which it would inevitably lead could scarcely fail of ending either in revolution or in national poverty and degradation. Economy in expenditure is, upon all occasions, the first virtue of government, and the most pressing of its duties.
>
> (McCulloch 1830b: 535–6)[5]

It appears McCulloch believed that the functions of the state should be restricted to security, defence, and the provision of justice. This impression is confirmed by the first edition of *Treatise on Taxation*, where McCulloch listed the items on which public revenue should be spent. They were: (1) good order and tranquillity at home; (2) security from foreign invasion; and (3) speedy and impartial administration of justice. These were necessary for the vigorous exercise of industry, the accumulation of wealth, and the well-being of society. However, McCulloch argued:

> it is no part of our business to inquire whether the revenue raised by the state exceed its necessary wants, or whether it be judiciously expended. How important soever, these questions do not affect the principles on which taxes should be imposed, nor the mode of their imposition, and are consequently foreign to the nature and objects of this work: and, leaving them to be examined by others, we shall

> content ourselves with endeavouring to ascertain the influence of taxation over individual and national wealth.
>
> (McCulloch 1995 [1845]: 3)[6]

In other words, McCulloch concentrated his attention on the analysis of taxation, without entering into a detailed discussion of how much government expenditure could be allowed for every item.

7.3 The principles of taxation

When McCulloch started to write on taxation, he did not question Smith's four maxims of taxation, namely equality, certainty, convenience, and economy (McCulloch 1824b: 6). However, in the first edition of *Treatise on Taxation*, McCulloch argued that 'the characters of good and bad taxes embodied in the above maxims are not sufficiently comprehensive' (McCulloch 1995 [1845]: 19). McCulloch considered Smith's maxim of equality – taxation in proportion to one's means – practically impossible. Although the maxim of equality was essential to direct taxes, it should not be applied to indirect taxes. McCulloch argued:

> in laying down a principle that is to apply to all taxes, equality of contribution is an inferior consideration. The distinguishing characteristic of the best tax is, not that it is most nearly proportioned to the means of individuals, but that it is easily assessed and collected, and is, at the same time, most conducive . . . to the public interests.
>
> (McCulloch 1995 [1845]: 19)[7]

Although McCulloch ranked the maxim of equality below the other three maxims, he did not ignore equality in examining various taxes. McCulloch always objected to any tax imposed on a specific class: he also accepted that compensation was necessary if a specific class was taxed more heavily than other classes. Thus, McCulloch replaced Smith's maxim of interpersonal equality with inter-sectoral equality, keeping it as his maxim of equality.[8]

In contrast to Smith and Ricardo, McCulloch attached importance to the proposition that taxation would promote the taxpayer's industry, as well as economy. McCulloch argued: 'Smith forgot that an increase of taxation has the same powerful influence over a nation that an increase of his family or of his necessary expenses has over a private individual' (McCulloch 1995 [1845]: 10).[9] McCulloch borrowed this proposition from Hume. If the 'promotion effect' on industry and economy compensated for the amount of the tax, economic growth would not be disturbed by the tax. However, such a promotion effect held true only in the case of a moderate tax. An oppressive tax would make taxpayers indolent, dispirited and impoverished, and consequently prevent economic growth.

At first, McCulloch believed that '[i]ncrease of exertion is not an exclusive consequence of indirect taxation; but it is an exclusive consequence of *moderate* taxation, whether it be direct or indirect' (McCulloch 1824b: 21; emphasis in original). Later, however, McCulloch modified this view. In the third edition of *Treatise on Taxation*, McCulloch argued for the superiority of indirect taxes to direct taxes on this point:

> Supposing that the insuperable difficulty of fairly assessing taxes upon property and income were to be overcome, they would probably have nearly the same influence as indirect taxes in promoting habits of economy or saving among the contributors. But exclusive of their influence in this respect, indirect taxes have a farther, as well as a peculiar and powerful, influence in stimulating industry, invention, and enterprise. And it is in this that their great and distinguishing superiority mainly consists.
>
> (McCulloch 1975 [1863]: 158)

Whereas taxes on property and income would promote only the taxpayer's economy, a tax on commodities would also stimulate industry, invention, and the enterprise of the producers of the commodity taxed. In particular, invention of a new production method to reduce the cost of the taxed commodity would increase national wealth by more than the amount of the tax (McCulloch 1995 [1860]: 57).

McCulloch acknowledged the defects of indirect taxes, as well as their advantages. In the 1824 *Encyclopaedia* article, McCulloch claimed that indirect taxes would increase the price of the commodity taxed and prevent the most efficient distribution of capital and labour; that they would promote smuggling; and that they would impose a heavier burden on the poor more than the rich (McCulloch 1824b: 21–2). However, in the 1842 article, McCulloch argued that these defects 'have been much exaggerated' (McCulloch 1842: 110). Because the price increased only when a tax was first imposed, the disturbance to the distribution of capital and labour would occur just once. Moreover, because a tax on commodities would stimulate invention and economy, and reduce their cost, the price of the commodities taxed would not increase in proportion to the tax. Smuggling could be prevented by confining the tax rate within reasonable limits. Although taxes on commodities might be regressive, they could not be said to be unequal. They were not imposed on a specific class. People could avoid the tax by refraining from consumption of the taxed commodity. Thus, McCulloch concluded that '[w]e must . . . resort to the best practicable taxes; that is, to duties on commodities' (McCulloch 1842: 111). In the 1860 article, McCulloch added that 'when most mischievous, [indirect taxes] are innocuous compared with direct taxes on property, income, and so forth' (McCulloch 1995 [1860]: 57). As time passed, McCulloch's attitude became more and more favourable towards indirect taxes.

7.4 Direct taxes

7.4.1 Tax on rent

The theory of differential rent claimed that a tax imposed in proportion to the rent of land would fall on the rent, keeping the price of raw produce unchanged. Although McCulloch regarded the theory of differential rent as true in principle, he did not think that its conclusion concerning the incidence of a tax on rent was consistent with real circumstances. In reality, the rent of land was composed of two parts: the part due to the natural power of the soil – the pure rent; and the part due to the capital invested on the farm – the capital return. The differential rent theory could apply only to the pure rent. A tax which fell on the capital return would impede improvement of the land, and increase the price of raw produce: the tax would fall on the consumer of raw produce. However, because it was practically impossible to distinguish the pure rent from the capital return, the ultimate incidence of a tax levied in proportion to the gross rent could not be determined.

As long as the tax fell on the capital return, it was objectionable, because it would impede improvements to the land. Even if it had been possible to impose a tax on the pure rent alone, such a special tax would have violated inter-sectoral equality. Thus, McCulloch concluded that '[i]n a practical point of view, taxes on the rent of land are among the most unjust and impolitic that can be imagined' (McCulloch 1842: 101).[10]

The theory of differential rent predicted that the rent of land would increase as population and demand for raw produce increased. As will be shown in the following chapter, James Mill proposed a special tax on the future increase in rent (see Section 8.4.2.1, pages 189–91). He believed that the government had a right to tax an increase in pure rent, because such an increase was produced by the government's economic and social policies, not by the landlord's exertions.

McCulloch did not accept James Mill's scheme. McCulloch thought that when a property right had once been established in any kind of property, the owner should be entitled not only to all the benefits now derivable from it, but also all those of which it would be productive in the future. Moreover, if Mill's view was accepted, the government would have a right to impose a special tax on profits when the Corn Laws were repealed. McCulloch argued:

> It is possible for the government, by repealing the corn laws and admitting the free importation of raw produce, to raise the profits of stock. But no one would, therefore, contend, that government would be justified in laying a tax on profits equivalent to the rise that had thus been occasioned; and if not, why should they be justified in laying an exclusive tax on rent when it rises in consequence of any measure of theirs?
> (McCulloch 1823c: 665)[11]

In turn, James Mill criticized McCulloch for regarding the rent of land as subject to the same taxation as the profits of capital:

> I utterly disallow the parallelism of the case of capital, which Mr. M'Culloch has adduced; as if because increased profits of stock ought not to be exclusively taxed, therefore the rent, which accrues in the manner above supposed, could not be justly appropriated to the service of the state. Nobody is more aware of the fundamental differences between profits of stock and rent of land than Mr. M'Culloch; it is, therefore, the more surprising that he should have founded his argument on an agreement between them, which does not exist.
>
> (Mill 1824: 248–9)

Ricardo was on McCulloch's side. In his notes on Mill's *Elements of Political Economy*, Ricardo wrote:

> An objection may be made against this tax that it would tend to arrest improvement or would finally in some cases fall on the consumer of raw produce; I mean in the case of a landlord expending a great deal of capital on his land for which he receives a return not under the name of profit, but under the name of rent. . . . On the whole I should greatly prefer the present system of taxation.
>
> (Sraffa 1951–73, vol. 9: 132)

Thus, Ricardo believed that, because it was practically impossible to distinguish the natural increase in the rent from the increase in the return on capital invested in the land, Mill's tax scheme would impede improvements to the land. Ricardo thought that the existing land tax – which was assessed on the basis of the fixed value of land – should not be changed for one that varied subject to the increase in the value of land. McCulloch followed Ricardo's opinion.[12]

Whereas McCulloch rejected any special taxes on the rent of land, he approved a tax on the rent from houses. The rent of a house consisted of a return on the capital invested in the building – the building rent – and a rent ascribed to the location of the land – the ground rent. With respect to the incidence of the tax, McCulloch argued:

> if the supply of houses could be as easily diminished and increased as the supply of raw produce, a tax on their rents would fall entirely on the occupiers and ground landlords, in the proportion that the profits of the capital laid out on them bore to the rent of the land on which they stood.
>
> (McCulloch 1842: 102)[13]

As long as a house tax fell on the landowner, it was a special tax on land. In the countryside, the proportion of the ground rent to the building rent was usually small: hence, the problem of a special tax would be minimal. However, in a town, where many buildings were used as shops and for business, the proportion of the ground rent was comparatively large: thus, a house tax would fall mainly on the landowners. In order to solve this problem, McCulloch proposed to exempt shops and buildings for business from a house tax, and confine it to buildings or parts of buildings used as dwelling houses. By this exemption policy, a house tax could avoid being a special tax on land tenure, and could be a fair tax imposed on expenditure on dwellings.[14] Thus, McCulloch could conclude that 'when these taxes [on houses] are assessed according to the rent, they are among the least exceptionable that can be devised' (McCulloch 1995 [1845]: 69). McCulloch consistently maintained this opinion.[15]

7.4.2 Tax on profits

In the 1824 *Encyclopaedia* article, McCulloch supported Ricardo's argument that a tax levied equally on profits in all sectors of industry would fall on all profits, keeping the relative prices unaltered. McCulloch also referred to Ricardo's discussion of a tax imposed only on profits in the agricultural sector. Such a tax would increase the price of raw produce, and consequently fall on consumers. The money rent would increase because of the increase in the price of raw produce. From Ricardo's proposition, McCulloch derived the following conclusion:

> [Ricardo's proposition] is a principle of the highest importance. It shows the unfounded nature of the complaints made by the landlords of the injuries *they* suffer from the operation of taxes on agricultural industry: It shows that such taxes as fall equally on agriculture and on other businesses neither affect rents nor prices, and cannot, therefore, be injurious to the landlords: And it further shows that such taxes as fall exclusively on agricultural profits must, by raising the relative value of corn, raise rents, and materially improve their condition!
>
> (McCulloch 1824b: 13; emphasis in original)[16]

In 1824, McCulloch was still influenced by the Ricardian belief in a conflict between the interest of landlords and that of the other classes.

However, in the 1842 article, McCulloch eliminated the above sentences, and modified Ricardo's proposition concerning a tax on profits. Regarding a tax levied equally on profits in all industries, McCulloch thought that it was practically impossible to assess the rate of profit in different businesses. In fact, the income tax introduced in the years 1798–1816 proved this to be true. McCulloch argued:

> In truth and reality, profits never have been and never can be taxed in proportion to their amount; and though it be important to know how a

> tax on profits would operate were it equally imposed, it must be kept in mind that this is altogether impracticable, and that the supposition is made merely to illustrate a principle.
>
> (McCulloch 1842: 103)[17]

To McCulloch, a tax levied on profits in all sectors did not deserve serious examination.

McCulloch also indicated that, in order to verify Ricardo's argument concerning a tax on agricultural profits, it was necessary to assume that raw produce – typically corn – was not imported.[18] If foreign corn was freely imported, the increase in the price of corn because of the tax would diminish demand for domestic corn, and increase demand for foreign corn. Domestic production of corn – hence cultivation of land – would be reduced, and consequently the rent of land would diminish. On the basis of this revised proposition, McCulloch concluded: 'in the event of any peculiar tax being imposed on the land, it is necessary, if we would do justice to all parties, that an equivalent duty should be laid on the importation of foreign agricultural produce' (McCulloch 1842: 103). A similar argument applied to a tax on raw produce (see Section 7.5.2, page 159).

In the newly added paragraph in the 1860 article, McCulloch indicated that in the case of free importation of corn, the proposition was unrealistic. It was practically difficult to assess the profits of different farmers fairly. Moreover, if a countervailing duty was imposed on foreign corn, the incidence of the tax on agricultural profits would become more ambiguous. For, whereas the negative effect of the tax on improvements of land would be immediate and direct, the effect of the countervailing duty would be slow and indirect. Thus, to McCulloch, all discussions about a tax on profits were 'not really, in one case in ten, of the smallest value in a practical point of view' (McCulloch 1995 [1860]: 46).

7.4.3 Tax on wages

In the 1820s, on the basis of the Malthusian principle of population, McCulloch supported Ricardo's proposition that a tax on wages would fall on employers – not labourers – although he made several qualifications (McCulloch 1823b: 617, 1824b: 14, 1995 [1827]: 391, and 1828b: 541–5). However, after abandoning Malthusianism, McCulloch indicated that labourers could incur the burden of a tax on wages.[19] In the first edition of *Treatise on Taxation*, McCulloch systematically demonstrated the incidence and effects of a tax on wages (McCulloch 1995 [1845]: 94–112). If a tax was imposed on time-rate wages, labourers would have to accept a reduction in their wages by the amount of the tax, or would shift the burden onto their employers in the form of higher wages. In contrast, if a tax was imposed on piece-rate wages – and if the tax rate was not high – the labourers would work harder in order to compensate for the amount of the tax. In this case, wages per unit of labour time would not increase, and consequently, the rate of profit would not be influenced by the tax. Thus, Ricardo's proposition did not apply to the piece-rate system.[20]

Let a tax be levied on time-rate wages. If the revenue financed by the tax was laid out in employing additional civil servants, demand for labour would increase, and wages would rise to cover the amount of the tax. The ultimate burden of the tax would fall on profits. Ricardo's proposition was verified in this case.

In contrast, if the revenue was used to increase salaries of civil servants already employed, demand for labour would not increase, and consequently wages would not rise. The labourers had to incur the burden of the tax and put up with the lower standard of living, at least for a while. If the lower standard of living made labourers delay the period of marriage and lower the birth-rate, the progress of the population would be checked. Consequently, in the long run, wages would rise and the rate of profit would fall.

However, if the labourers were acclimatized to the lower standard of living, and kept their habits of marriage, the progress of population would not be checked. McCulloch argued that this would often be the case, showing that the natural rate of wages had a tendency to rise and fall together with the market rate of wages (McCulloch 1995 [1845]: 100).[21] Without a population check, a diminution in wages because of the tax would not be recovered. In a growing economy where demand for labour continued to increase and wages tended to rise, the labourers' suffering from the tax would not last long. However, if the economy was stationary or in recession, their suffering would be perpetual.

Thus, Ricardo's proposition – that a tax on wages would fall on profits – held true only in two cases: (1) if wages were paid for time work and the tax revenue was used to employ additional civil servants; and (2) if wages were paid for time work, the tax revenue was used to increase salaries of civil servants already employed, and the growth of the labouring population was checked by the Malthusian principle when the market rate of wages fell. In contrast, if wages were paid for piece work, or if the growth of population did not decline when wages fell, Ricardo's proposition did not hold true: the labourer would incur the burden of the tax. Even in the cases in which Ricardo's proposition held true, capital accumulation would slow down because of lower profits. Consequently, demand for labour would be less, and wages would be lower than without the tax. Thus, in any case, a tax on wages would prevent the improvement of the labourers' condition. For this reason, McCulloch did not accept a direct tax on wages (McCulloch 1995 [1845]: 107).

In the 1860 *Encyclopaedia* article, McCulloch indicated that, because a direct tax on wages was merely fictitious, it deserved no more serious examination than a direct tax on profits. McCulloch argued that '[n]o government has ever attempted to lay direct taxes on wages; and were such an attempt made it would be sure to fail, inasmuch as the tax could neither be assessed nor collected' (McCulloch 1995 [1860]: 50).

However, there existed indirect taxes on wages, namely taxes imposed on commodities which labourers consumed. Although McCulloch acknowledged that taxes on wage goods would have the same effect as a direct tax on wages, he had less objection to the taxes on wage goods as long as they were confined within moderate limits. Although McCulloch's view of a tax on wage goods will be examined in more detail in Section 7.5.1 – on taxes on necessities and luxuries – it must be noted here that he finally rejected the Ricardian reciprocal relationship between wages and profits:

> it does not follow, as Ricardo supposed, that every rise of wages is necessarily accompanied by a corresponding fall of profits. On the contrary, . . . both wages and profits may simultaneously rise; and this is always the case when a rise of wages is accompanied or followed by a corresponding increase in the productiveness of industry. It is found, too, that practically this is the usual effect of an increase either of wages or taxes. Such increase stimulates the producers to endeavour, by fresh displays of industry, invention, and economy, to preserve unimpaired their accustomed profits, and the markets for their goods. And the impetus thus given is, in very many cases, more than enough to secure both results.
>
> (McCulloch 1995 [1860]: 64)

On the basis of the non-reciprocal relationship between wages and profits McCulloch could support moderate indirect taxes more strongly, even if they were imposed on the commodities which labourers consumed.

7.4.4 Income tax

Through his writings on taxation, McCulloch consistently maintained an unfavourable attitude to taxes on property and income. In the 1820s, McCulloch objected to the scheme of introducing a property tax or an income tax in order to reduce and repeal oppressive indirect taxes (McCulloch 1819b: 173, 1820c: 164, 1822a: 27, and 1823f: 761–2). McCulloch thought that such direct taxes were unnecessary, because lower rates of indirect taxation would produce more revenue by increasing demand for commodities and preventing smuggling.[22] When Henry Parnell published *On Financial Reform*, McCulloch wrote:

> What the country really wants is not a new system of taxation, but an improvement in the system now in use. By reducing some duties, and repealing a few others, the pressure of taxation may be greatly alleviated, without the revenue being in any degree diminished.
>
> (McCulloch 1830a: 224)

To McCulloch, a property tax was more objectionable than an income tax. A property tax would violate inter-sectoral equality, because it would fall on property-holders – typically landlords and capital-holders – while exempting non-propertied classes – for example, professionals. Moreover, it would be practically difficult to assess the taxable value of individual property – namely to calculate and deduct the depreciation of the property and the cost of improvements. The tax was unjust, because it would be imposed on property which produced no income, as well as on income-yielding property. A heavy tax on property would impede capital accumulation and promote capital exportation. For all these reasons, McCulloch did not accept a property tax.[23]

By comparison, an income tax would keep income distribution unchanged, if it was fairly assessed. According to McCulloch, an income tax – if it was to be a fair tax – should be imposed in proportion to the capitalized value of one's income with respect to its duration: for example, supposing the discount rate to be zero, income of £10 paid for 30 years and income of £50 for 6 years had to pay an equal one-time tax.[24] McCulloch never approved of raising the tax rate as the capitalized value of income increased.[25] A progressive tax would hinder people's incentives to work, retard capital accumulation, and violate inter-sectoral equality. Moreover, once the rule of proportionality was abandoned, we would be 'at sea without rudder or compass' (McCulloch 1995 [1845]: 143). Although McCulloch accepted progressiveness produced by the exemption of subsistence income, he worried that the minimum exemption would be determined by political tactics, and easily exceed subsistence income. Thus, McCulloch believed that an income tax would become 'an engine of misgovernment' (McCulloch 1995 [1845]: 139).[26] This observation was proved to be true by subsequent historical experience (Shehab 1953: 86–172).

Although an income tax had to be as proportional as possible to the value of capitalized income, it was practically impossible to create such a tax. McCulloch indicated two difficulties: (1) the difficulty of ascertaining the annual income of different individuals; and (2) the difficulty of imposing an equal tax on incomes of varying durations.[27]

First, whereas the rents of land and houses, interest on bonds, and dividends of stock could be learned without a great difficulty, incomes of farmers, manufacturers, dealers, and professionals could not be captured precisely: they could easily hide their incomes and evade an income tax. This was proved by the fact that the yield of Peel's income tax was much smaller than expected with respect to Schedule D – business and professional incomes. Thus, the income tax was a tax on honesty and a bounty on fraud.

In the 1820s, McCulloch believed that the Ricardian adjustment mechanism would work in the long run. Even if professionals could escape from an income tax, their rewards would gradually diminish because of a free movement of labour between occupations; consequently, an income tax would keep their relative position unaltered (McCulloch 1823d: 13–15 and 1824b: 17–18). However, in the 1842 *Encyclopaedia* article, McCulloch explicitly rejected this argument (McCulloch 1842: 107). In reality, professional fees were not easily altered once they were fixed, and, as long as an income tax was moderate, it would not influence the fees even in the long run. Thus, the most objectionable defect of an income tax – tax evasion – could not be solved by the Ricardian adjustment mechanism.

Moreover, in order to be fair to propertied incomes, it was necessary to calculate and exempt from the tax the depreciation of the property and the cost of improvements. This made it difficult to ascertain net rents of land and houses, and net profits on productive capital.

Even if individual annual income had been precisely assessed and captured, an income tax would encounter a second difficulty, namely the difficulty of imposing an equal tax on incomes of different durations. In order to make an income tax equal, the duration of income with respect to each taxpayer had to be ascertained. The duration of income depended on the expected life of the taxpayer, as well as on the duration of the income source. However, the duration of a taxpayer's life could be ascertained only by an average rule, for example through insurance statistics. Even if the duration of individual income could have been ascertained, it would have been necessary to select an interest rate at which income should be discounted. However, there was no agreement about what rate of interest could be a representative discount rate.

All these arguments simply indicated how impossible it would be to assess a fair income tax. McCulloch recognized that the second difficulty of an income tax could be avoided by making it perpetual and invariable (McCulloch 1995 [1860]: 55). In this case, every taxpayer would pay an income tax in proportion to his annual income until the end of its duration. However, the first difficulty – the difficulty of ascertaining annual incomes of different individuals – would remain, and the most objectionable defect of an income tax – the custom of tax evasion – would be perpetuated. Thus, McCulloch's opinion that an income tax was unsuitable as an ordinary source of revenue was not influenced by the scheme to make it perpetual. Until the end of his life, McCulloch continued to insist on reserving an income tax for financing urgent expenditure, typically on a war. In the third edition of *Treatise on Taxation*, McCulloch argued:

> Hence the advantage of reserving taxes on income as a resource to be made use of in seasons of difficulty and danger. They are then in their proper place. The exigency of the crisis makes their inequality and oppressiveness be overlooked, or submitted to with little murmuring from the consciousness of their being indispensable. . . . Those who exhaust an income-tax in seasons of tranquillity deprive themselves, when they are especially wanted, of the services of a most powerful engine, whether for defence or offence.
>
> (McCulloch 1975 [1863]: 141)

McCulloch expected that the existing income tax would not last for long. In fact a number of petitions for its abolition were raised in Parliament. However, contrary to McCulloch's anticipation, the income tax was not abolished.[28]

7.5 Indirect taxes

7.5.1 Tax on necessities and luxuries

McCulloch examined a general *ad valorem* tax – a tax imposed in proportion to the prices of all commodities. In the 1824 *Encyclopaedia* article, McCulloch supported Ricardo's and James Mill's proposition that a general *ad valorem* tax would raise the average price level, keeping relative prices unchanged (McCulloch 1824b: 23). However, in a note on Smith's *Wealth of Nations*, which McCulloch edited in 1828, he rejected this proposition, and indicated the opposite conclusion: if the quantity of money was constant in the country, a general *ad valorem* tax would change relative prices, keeping the average price level unchanged (McCulloch 1828b: 555–8). McCulloch reproduced this conclusion in the 1842 *Encyclopaedia* article (McCulloch 1842: 111–12). However, McCulloch avoided going too far into a theoretical examination of this tax, because he thought that 'it is one that can never be brought to any practical test', and that 'it is quite out of the question to suppose that such a duty . . . could ever be imposed on the infinite variety of commodities produced within any extensive country' (McCulloch 1828b: 558). In the 1860 *Encyclopaedia* article, McCulloch eliminated the paragraph which indicated that a general *ad valorem* tax kept the average price level unchanged (McCulloch 1995 [1860]: 58–9).

McCulloch believed that a tax on a particular commodity would increase the price of the commodity taxed. If a tax was imposed on the necessities of life, it would produce the same effect as a tax on wages. The tax would fall on wages or profits.

In the article 'Taxation and the Corn-Laws' (1820), McCulloch attributed the present economic depression and increase in the number of the poor to oppressive taxes on necessities, as well as the restrictions on importation of corn. McCulloch estimated the burden incurred by the people because of the heavy taxes and the high price of corn at a third of national income (McCulloch 1820b: 177–8). In particular, such a burden impoverished the labourers. If they became accustomed to the lower standard of living, their poverty would be perpetual. If they checked the progress of their population, wages would rise. However, because an increase in wages would reduce profits, capital accumulation and growth of demand for labour would slow down. Consequently, 'in both, [taxes on necessities] are, in the end, nearly equally destructive of the happiness and future improvement of the society in which they have been carried to an inordinate extent' (McCulloch 1820b: 165). Thus, McCulloch proposed '[a]n effectual reduction of taxation' and 'a cautious and gradual repeal of the restrictions on the trade in corn' (McCulloch 1820b: 179).[29]

As McCulloch wished, a number of excise and customs duties were reduced and abolished by Robinson and Huskisson in the 1820s, by Peel in the 1840s, and by Gladstone in the 1850s and 1860s. The Corn Laws were abolished in 1846. McCulloch argued in 1845:

> with the exception of the duty on glass . . . we are not sure that there is one of the existing duties that can be fairly objected to on principle, though the rate of duty might, perhaps, in one or two cases be advantageously reduced.
>
> (McCulloch 1995 [1845]: 233)

By 1860 McCulloch came to think that too many excise and customs duties had been abolished (McCulloch 1968 [1852]: 241 and 1995 [1860]: 59). He believed that some of the indirect taxes that had been abolished would have been much less objectionable than the income tax. Thus, McCulloch became more favourable to indirect taxes, and this influenced his view on the incidence and effects of taxes on necessities.

In the first edition of *Treatise on Taxation*, McCulloch argued that 'the practical influence of taxes on necessaries depends principally on their amount, and on the state of the country in which they are imposed' (McCulloch 1995 [1845]: 160–1). If taxes on necessities were moderate, and if the economy was growing and demand for labour was increasing, the labourers would increase their industry and economy: consequently, although the money wage rate would not rise, the labourers would not be impoverished. In contrast, however, if the taxes were oppressive, or the economy was stationary or declining, such a stimulus on industry and economy would not be produced. Consequently, the labourers would be impoverished. If the progress of population was checked, wages would rise and profits would fall in the long run. McCulloch argued that it was impossible to indicate a priori which would occur.

As has been shown in the section on a tax on wages (page 154), McCulloch finally rejected the Ricardian reciprocal relationship between wages and profits. McCulloch argued that a rise in wages – if it was moderate – would stimulate the producers' industry, invention and economy, and that their profits would increase as a result of the stimulus (McCulloch 1995 [1860]: 64). If this was the case, moderate taxes on necessities would injure neither the labourers nor the capitalists.

Taxes on luxuries consumed by the rich – for example, rich wines, finest laces, velvets, silks, porcelain, and ornamental furniture – would fall on the consumers. McCulloch did not think such taxes objectionable, although he argued that too high a tax would not be productive, because people would escape by refraining from consumption of the taxed commodity (McCulloch 1995 [1845]: 168).[30] McCulloch did not think it possible to assess a priori the incidence and effects of taxes on luxuries consumed by labourers, such as sugar, tobacco, tea, and spirits. However, if the taxes were moderate, they would promote the industry and economy of the labourers. Hence, 'should the country be in an advancing state there is every probability that the labourers would sustain little or no injury from the tax' (McCulloch 1968 [1852]: 165).[31] Thus, McCulloch conceded the retention of taxes on luxuries consumed by the labourers, as well as those on luxuries consumed by the rich.

7.5.2 Tax on raw produce

In the article 'Tithes' in *Edinburgh Review*, 1820, McCulloch supported Ricardo's proposition that taxes imposed in proportion to the yield of raw produce would raise its price, directly by increasing the cost in the marginal land, and indirectly by impeding improvements to the land. The increase in the price of raw produce would raise wages and lower the profits of all industries. Consequently, national capital accumulation would slow down. Thus, taxes on raw produce – although they were harmful – were not partial taxes falling on the landlords and farmers: they could not make tithes a valid reason for the restrictions on importation of corn (McCulloch 1820d: 61).[32]

McCulloch thought the existing tithes 'the very worst that could have been devised' (McCulloch 1820d: 61). In order to reduce the harmful effects of tithes on improvements to land and capital accumulation, he proposed to commutate them into a proportional tax on rents of lands and houses (McCulloch 1820d: 77).[33] However, it was unjust to impose a special tax on land. McCulloch answered this problem by claiming that a tax imposed on the capital invested by the landlords on the land would finally fall on the public.

In the *Scotsman* in 1823, McCulloch acknowledged that the rent of land would be reduced by tithes, if foreign corn was freely imported. A higher price of domestic corn because of tithes would increase demand for foreign corn and decrease demand for domestic corn. Consequently, a portion of land would be thrown out of cultivation, and the rent of land – as well as the farmers' profits – would diminish. In order to compensate for the special burden on the agricultural sector, McCulloch adopted Ricardo's proposal of a fixed duty on imported corn – accompanied by a drawback on exportation. However, he argued that '[t]he necessity of imposing this countervailing duty, originating ... in the imposition of tithes, affords another and a very powerful argument in favour of their abolition or commutation' (McCulloch 1823a: 546).[34] Thus, McCulloch emphasized the necessity of a countervailing duty in order to highlight the inconvenience of tithes. McCulloch demonstrated that, if tithes were abolished, the countervailing duty could be reduced to a lower level than Ricardo had proposed.[35]

In a note to *Wealth of Nations*, McCulloch demonstrated that Ricardo's proposition concerning the incidence and effects of tithes needed three assumptions: (1) demand for corn was inelastic; (2) all land was tithed; (3) no corn was imported (McCulloch 1828b: 548–52). In fact, however, demand for corn was not completely inelastic. A great proportion of land in Britain was untithed. Moreover, if the Corn Laws were abolished, corn would be freely imported. Consequently, tithes would reduce the rent of land, by diminishing demand for corn, throwing out a portion of tithed land from cultivation, and replacing domestic corn with foreign corn.

By the Commutation Act in 1836, tithes were commuted to a rent-charge fixed in terms of corn. The clergy received the value of corn rent according to the seven-year-average price (later, the current price) of corn. Moreover, because of the repeal of the Corn Laws in 1846, foreign corn was imported freely at a fixed duty of 1 shilling.

The commutation of tithes and the repeal of the Corn Laws made McCulloch more confident that tithes would fall at least partly on land. In his writings after 1836, McCulloch repeated that the three conditions for Ricardo's proposition of tithes were not consistent with the real circumstances.[36] Because the mode of assessment had been improved, the present tithe was not objectionable. In 1863, McCulloch argued:

> whatever may be the defects of the Commutation Act, it must, on the whole, be regarded as eminently successful; the rent fixed under it cannot be augmented, and tithe has ceased to be an obstacle to improvements, and a source of quarrelling and litigation.
>
> (McCulloch 1975 [1863]: 194)

However, the problem remained that tithes were a partial tax imposed on land. McCulloch believed it necessary to impose a fixed duty on foreign corn in order to compensate for the higher level of taxes in the agricultural sector relative to the manufacturing sector. Although McCulloch praised the abolition of the Corn Laws, he regretted that a fixed duty on foreign corn higher than 1 shilling had not been accepted in 1846. McCulloch believed that a higher duty – for example, 3 shillings a quarter – would have not only done justice to landlords, but also produced more revenue to the government without preventing trade and industry (McCulloch 1968 [1852]: 193–202 and 1975 [1863]: 196–8).

7.5.3 Customs duties

Before 1842, McCulloch was enthusiastic about a reduction of import duties in general, as well as commutation of the Corn Laws to a fixed countervailing duty. McCulloch argued that a reduction of import duties would not diminish the total revenue they generated, because such a reduction would increase demand for foreign commodities and prevent smuggling.

According to McCulloch, whereas import duties would fall on domestic consumers, export duties would fall on foreign consumers. Hence, 'when a country possesses any exclusive, natural, or acquired advantage, in the production of commodities, a duty on their exportation is really the most unexceptionable of all taxes' (McCulloch 1824b: 27). Coal and tin in Britain, for example, were suitable for export duties. Thus, McCulloch claimed that the government had to abolish the Corn Laws, reduce import duties and raise revenue from several export duties.

However, after Peel resumed tariff reform in 1842, McCulloch became more sympathetic towards import duties. McCulloch maintained that a reduction in the rates of customs duties would produce a larger revenue, that unproductive duties had to be abolished, and that duties on materials for manufactures had to be restricted as low as possible. However, McCulloch did not think it a good policy to repeal productive duties on consumption goods. The government would lose an important source of revenue and could not help relying on more objectionable measures, for example, an income tax. Thus, McCulloch warned Peel against repealing an excessive number of duties, insisting that 'moderate duties on imports are at once among the most productive and the least objectionable of all taxes' (McCulloch 1842: 115).[37]

By Gladstone's tariff reforms in 1853 and 1860, the number of articles subject to customs duties was reduced, from the 400 which Peel had left, to 48. In the third edition of *Treatise on Taxation*, McCulloch argued that Gladstone's tariff reforms went too far: 'in stead of being so greatly reduced, it would have been much better had the tariff continued, in respect at least of the number of articles, on the footing it was left by Sir Robert Peel' (McCulloch 1975 [1863]: 224–5). Because of this reduction, the government had lost an important branch of revenue. The government would have to make up a future shortage of revenue by raising the rates of remaining customs duties.[38] However, it would be inequitable to increase the tariff rate on particular commodities, while keeping other commodities tax-free. Moreover, the remaining duties were mainly composed of those on commodities consumed by labourers – for example, tea, sugar, tobacco, and spirits. An increase in these taxes might provoke popular complaint, and their abolition would produce a great loss to the public revenue. Thus, McCulloch concluded that 'instead of narrowing the area of indirect taxation, the safer and better plan is to widen it, so that it may comprise every description of easily assessed and moderate duties' (McCulloch 1975 [1863]: 226).

McCulloch did not think that moderate duties imposed in a wide range of commodities contradicted the principle of free trade, for such duties treated every commodity equally.[39] In contrast, customs duties imposed on particular commodities contradicted the principle of free trade, because such duties treated commodities unequally and arbitrarily. Gladstone's tariff policy embodied this contradiction. McCulloch wrote: 'that [the unequal system of tariffs] should have been introduced and grown up consentaneously with that free-trade policy of which it is wholly subversive, is one of the most striking contradictions of which we have any account' (McCulloch 1975 [1863]: 229).

7.5.4 Inheritance tax

In 1824, McCulloch wrote an article for the *Edinburgh Review* in support of the English law of succession. The law provided – with respect to an intestate succession – that realty, as well as personalty which was settled upon the eldest son, was inherited by him, and that unsettled personalty was divided equally between the other children.[40] Although this rule was not applied to succession where a will existed, it influenced the retention of primogeniture. McCulloch did not favour changing the English law to the French system, in which the effectiveness of a will was restricted and intestate property was equally divided between all children. McCulloch thought that whereas the law and custom of primogeniture stimulated younger children to cultivate their talents and work hard in the new world, the system of equal division would deprive them of such a stimulus. Moreover, an equal division of land would increase the agricultural population, and impede mechanization and improvement of farming: consequently agricultural productivity would fall, and the price of corn would increase. Thus, the system of equal division would impoverish the people (McCulloch 1824a: 360–75).[41]

The Scottish law admitted perpetual entail, namely an inviolable settlement of the succession of a real estate. Land could not be bequeathed simply at the will of the possessor. In contrast, the English law limited entail to heirs in existence when the deed was executed, or to an unborn child. McCulloch thought the English system superior to the Scottish. The system of perpetual entail would make the heir lazy, because people would not work hard unless they could decide who would succeed to their property. The system of perpetual entail would deprive the heir of the incentive to improve the land, and prevent higher productivity in agriculture. Although such a system could be applied to particular aristocrats, it should not be extended to the general population. McCulloch proposed to alter the Scottish law to the English system (McCulloch 1824a: 354–60).

Thus, from the viewpoint of productivity in agriculture, McCulloch regarded the English system of primogeniture as superior to the French system of equal division and the Scottish system of perpetual entail. McCulloch restated this view in his pamphlet in 1848 – *A Treatise on the Succession to Property Vacant by Death* – when an imposition of inheritance taxes on realty and settled personalty was brought up for debate in Parliament.[42]

Before 1853, inheritance taxes in Britain were composed of the probate and administration duties and the legacy duty, all of which were imposed on unsettled personalty alone. Because realty and settled personalty were usually inherited by the eldest son, inheritance taxes fell mainly on younger children. Moreover, whereas the legacy duty was imposed in proportion to the value of property, the probate and administration duties were imposed regressively: the rate decreased as the value of property increased. In order to remove these inequalities, as well as to raise revenue, Gladstone introduced a new inheritance tax in 1853 – the succession duty – which targeted realty and settled personalty. This duty was levied in proportion to the capitalized value of the life annuity which the heir would receive. However, the succession duty did not produce as much revenue as had been expected.[43]

At first, following Smith's and Ricardo's view that inheritance taxes would impede capital accumulation, McCulloch did not approve of inheritance taxes (McCulloch 1824b: 29 and 1842: 117). Later on, McCulloch changed his view, and argued that inheritance taxes – if they were moderate – would stimulate parents' and heirs' frugality (McCulloch 1995 [1845]: 290).[44] However, McCulloch never accepted J. S. Mill's scheme of a progressive inheritance tax. In the second edition of *Treatise on Taxation*, McCulloch argued:

> [A progressive inheritance tax] is neither more nor less than an undisguised scheme of confiscation, and like all schemes of the sort it would be most pernicious. . . . [I]f every increase of a man's disposable wealth were to lead, in the event of his death, to an increased duty on successions, it would either make him relax in his efforts to amass, or tempt him to defeat so odious an impost by disposing of the greater portion of his fortune during his lifetime.
>
> (McCulloch 1968 [1852]: 303)[45]

Although McCulloch accepted the succession duty introduced in 1853, he thought that the system of inheritance taxes – namely the probate and administration duties and the legacy and succession duties – required further reform. First, the regressive nature of the existing probate and administration duties had to be corrected.[46] Moreover, the legacy and succession duties had to be imposed equally on land and movable property (McCulloch 1995 [1860]: 66 and 1975 [1863]: 298–9). According to McCulloch, the failure of the succession duty to raise sufficient revenue stemmed from its mode of imposition: whereas the legacy duty was imposed on the value of property, the succession duty was imposed on the capitalized value of the heir's life annuity. The mode of the succession duty had to be reformed to match the mode of the legacy duty. McCulloch concluded:

> The result of the present system of assessing the tax on real property is such that it is not supposed to yield half what it would yield, were it assessed in the same way that it is assessed on money and other

> personal property. It would require very conclusive reasons to justify a distinction of this sort. And, as none such really exist, the sooner the discrepancy is terminated, and the duty assessed in the same way on all descriptions of property, the better will it be for all parties, and especially for those who are short-sighted enough to suppose that they are benefited by the present system.
>
> (McCulloch 1975 [1863]: 301)

Although McCulloch approved of the law and custom of English primogeniture – which prevented the division of land – he did not accept the system of inheritance taxes which treated the landed class favourably. Such a discrepancy in the inheritance taxes would provoke people's antipathy against the law and custom of primogeniture, and justify a special tax on land and a progressive income tax. Thus, McCulloch believed that, in the long run, a fair system of inheritance taxes would benefit the landed class, as well as the public.

7.6 Public debt

According to McCulloch, 'the policy of raising the supplies for a war by means of loans, or by an equivalent increase of taxation, cannot be decided on general principles, but depends on the peculiar circumstances of the country at the time' (McCulloch 1995 [1845]: 409–10).[47] Debt financing was superior to taxation with regard to the facility with which money was supplied to the government. However, it had a fatal defect. In the case of taxation, people would consider the tax as a diminution of their enjoyment. Unless the tax was too oppressive, they would work harder and save more in order to compensate for the loss of such enjoyment. In contrast, in the case of public debt, such a stimulus would be weaker, because people did not realize that their fortune was reduced by the public debt: they would work harder and save more only for interest payments. Thus, from the viewpoint of economic growth, preference ought to be given to taxation.

McCulloch believed that Britain had relied on public debt too much since the Glorious Revolution. The public debt issued during the Revolution could be justified: because of the public debt, a new and weak government was able to defeat the ambitious projects of Louis XIV. However, the subsequent governments – although they were strong – continued to increase public debt in order to avoid a popular outcry against taxes.[48] Consequently, the cumulative debt made the people subject to perpetual taxes to finance the interest payments. Such taxes – if more accumulated – would depress profits and promote exportation of capital. Thus, considering the real circumstances in Britain, McCulloch stressed 'the importance of preventing, in as far as possible, the contraction of a large public debt, in the first instance, and of its substantial reduction if it should be contracted' (McCulloch 1995 [1845]: 427).[49]

McCulloch's first discussions of public debt reduction appeared in two essays in 1816: *An Essay on a Reduction of the Interest of the National Debt*; and *An Essay on the Questions of Reducing the Interest of the National Debt*. In the first essay, McCulloch argued that in order to abolish the Corn Laws and reduce taxes on necessities, government expenditure had to be reduced. How would such a retrenchment be effected? McCulloch's answer was by a reduction of the interest on the public debts which had been contracted during the Napoleonic Wars (McCulloch 1816a: 39). McCulloch did not think that such a reduction broke faith with public creditors. Because the public debts had been undertaken at a depreciated value of money, the public creditors benefited from the general fall in prices after the war: they received a higher real rate of interest. In contrast, the taxpayers, whose income fell in proportion to the fall in prices, had to incur a heavier burden of taxes for the interest payments. Moreover, if the Corn Laws were abolished, the general level of prices would fall further. Thus, in order to be fair to the taxpayers, the rate of interest on the public debt had to be reduced in proportion to the fall in prices. McCulloch proposed a reduction of the interest by about 25 per cent (McCulloch 1816a: 52–3).[50]

Despite Ricardo's criticism, McCulloch did not withdraw the interest reduction scheme in his second essay (see Section 6.4.1, pages 131–2). Instead McCulloch reinforced it, by arguing that in order to stabilize the prices in the long run, the Bank of England should resume the specie payment. However, prices would fall when the specie payment was resumed. The public creditor would make a further gain, and the taxpayer would suffer a further loss. Hence, the Bank of England could not 'be called upon to pay its notes in specie, without a reduction being made in the interest of the national debt' (McCulloch 1995 [1816b]: 191). However, after reading Robert Mushet's *Series of Tables, Exhibiting the Gain and Loss to the Fundholder, Arising from the Fluctuations in the Value of the Currency: from 1800 to 1821* (1821), and finding that the public creditors had lost – not gained – by the fluctuation of prices, McCulloch abandoned the interest reduction scheme. In 1826, McCulloch argued: 'if an *equitable* adjustment is to be gone into, we must consent to pay [the public creditors] £72,704 a-year more than we are obliged to do by the letter of the contract we have made with them' (McCulloch 1826a: 425; emphasis in original).

By 1820, McCulloch became a supporter of Archibald Hutcheson's and Ricardo's scheme of a capital levy. When Ricardo contributed an article on the 'Funding system' to the *Encyclopaedia Britannica*, McCulloch wrote in the *Scotsman* that '[i]f we have good sense and virtue enough to acknowledge the merits, and to act according to the plan recommended by Mr Ricardo, the country will yet rise superior to all its difficulties' (McCulloch 1820a: 10). McCulloch claimed that all public debts could be extinguished by a capital levy of 20 per cent. However, he was not completely convinced of the feasibility of the capital levy scheme. McCulloch wrote in

1820 that the scheme had to be considered as a '*dernier resort*' (McCulloch 1820b: 180). In 1827, McCulloch stated that 12 per cent – not 20 per cent – was the feasible rate of capital levy, and that half of the outstanding public debt could be extinguished by it (McCulloch 1995 [1827]: 408). In the following year, McCulloch confessed that he was not sanguine about the feasibility of a capital levy, even at 12 per cent (McCulloch 1995 [1828a]: 60).[51]

In the first edition of *Treatise on Taxation*, McCulloch dismissed the capital levy scheme, arguing that 'the project is wholly impracticable, and that, supposing it to be practicable, it would be most unjust to attempt to carry it into effect' (McCulloch 1995 [1845]: 464). A capital levy would be unjust, because it would not fall on professionals. In contrast to the 1820s, McCulloch did not believe that the Ricardian adjustment mechanism would keep the relative position of professionals by lowering their fees.[52]

McCulloch rejected not only the interest reduction scheme and a capital levy, but also the sinking fund of the fixed-transfer system and the growth of the fund at compound interest. Following Robert Hamilton, McCulloch argued that these systems had deceived the people and increased the public debt.[53] Thus, the only option open to McCulloch was the sinking fund on the basis of a budget surplus. However, in the first and second editions of *Treatise on Taxation*, McCulloch did not have recourse to the sinking fund. McCulloch argued that a surplus revenue ought to be used for a reduction of taxes rather than an extinction of the public debt:

> the national interests will be best promoted by reducing taxation to the sum necessary to meet the public exigencies, leaving it to the contributors to employ the sums remitted in taxes in any way they think best. The increase of wealth and population will be promoted by this policy. . . . The greater productiveness of industry and the greater well-being of the community, are the real sinking funds which a wise government should exert itself to build up and encourage.
>
> (McCulloch 1995 [1845]: 466)[54]

Thus, McCulloch favoured a balanced-finance policy. However, in the third edition, although he maintained that economic growth was the real sinking fund, McCulloch argued that a certain amount of annual surplus had to be maintained:

> We should do this, not so much in the view of reducing the debt, though that is a consideration not to be left entirely out of view, as of increasing our security, and enabling proper measures to be devised, in the event of our being engaged in war, for defraying its expense. . . . And supposing an efficient system of economy were at the same time enforced, wherever it may be practicable, and efforts continuously

> made to widen the present narrow basis of indirect taxation, the whole financial policy of the country would acquire great solidity.
>
> (McCulloch 1975 [1863]: 463)

McCulloch finally put forward a surplus-finance policy, in order to make provision for urgent expenses, rather than reduce the public debt. McCulloch concluded thus, probably because a reduction of taxes – in particular indirect taxes – had gone too far from his viewpoint, and the income tax – which should have been reserved for a war – had been imposed for more than twenty years of peacetime.

7.7 Conclusion

Although McCulloch allowed that public revenue could be spent for the purposes of: (1) good order and tranquillity at home; (2) security from foreign invasion; and (3) speedy and impartial administration of justice, he did not state how much government expenditure could be devoted to these purposes. McCulloch believed that the modes of financing government expenditure – namely, taxes and public debt – could be examined independently of the arguments about the scale of government expenditure.

Early in his writings, McCulloch supported several Ricardian propositions concerning taxation and public debt: (1) a tax on rent would fall on rent, keeping the price of raw produce unchanged; (2) a tax on profits and a tax on wages would fall on profits; (3) taxes on necessities would increase the price of the commodity taxed, raise wages, and finally fall on profits; (4) a tax on raw produce would raise the price of raw produce and wages, and fall on profits; (5) inheritance taxes would impede capital accumulation; (6) public debt could be best extinguished by a capital levy. These propositions implied that the interest of landlords conflicted with the interests of other classes, and that the interest of labourers conflicted with the interest of capitalists.

However, by the 1860s, McCulloch had modified all these propositions: (1') a tax on rent would fall on the public, as well as the landlords, because it would increase the price of raw produce; (2') a tax on profits and a tax on wages deserved no serious examination, because they were practically impossible; (3') taxes on necessities would not always increase wages, and even if they increased wages, profits would not always fall; (4') a tax on raw produce would fall at least partly on rent; (5') inheritance taxes would not prevent capital accumulation, if they were moderate; (6') the burden of public debt could be lightened by economic growth, as well as by an annual surplus of revenue.

McCulloch made these modifications in considering changes in circumstances between 1820 and 1860: the sinking fund of the fixed-transfer system was abolished in 1829; tithes commuted in 1836; the income tax reintroduced in 1842; the Corn Laws abolished in 1846; inheritance taxes reformed in 1853; and a number of excise and customs duties reduced or abolished by 1860.

McCulloch's modified propositions demonstrated that no tax could benefit (or harm) a particular class alone. Because every class depended on – not conflicted with – each other, any tax would affect all classes both directly and indirectly. Moreover, the extent of the influence on each class would differ according to circumstances. Therefore, the effects of taxes and public debt had to be examined on the basis of an interdependent relationship between classes, as well as of real circumstances. This was consistent with McCulloch's conclusion concerning the general principle of political economy:

> I have endeavoured to shew, that there is no real opposition of interests amongst the various classes of the community; that they are all mutually dependent upon each other; and that any favour or advantage given to one class, at the expense of the rest, is not only immediately injurious to the latter, and subversive of that equality of protection which every just government will always grant indiscriminately to all who are under its protection, but that it is not either really or lastingly beneficial to those whose interests it is intended to promote.
>
> (McCulloch 1830b: 536)[55]

McCulloch removed the Ricardian propositions of class conflict from his writings on public finance, as well as on political economy. As an indiscriminate measure of public finance towards all classes, McCulloch proposed moderate indirect taxes on a wider basis. Such a measure would create a surplus budget in order to provide for urgent expenses, and maintain economic growth, which in turn would lighten the burden of the public debt and taxation. Thus, a wider basis for moderate indirect taxes was McCulloch's final answer to the problems of debt management and of a fair and efficient system of taxation.

Notes

1 McCulloch argued that '[h]ad Dr Smith been acquainted with the real nature of rent, and with the circumstances which, in every stage of society, regulate the exchangeable value of commodities, he would doubtless have come to very different conclusions respecting the ultimate incidence and effects of various taxes' (McCulloch 1818: 84).

2 O'Brien (1970: 403) argues: 'for him abstract ideas on their own were of little interest; it was their practical conclusions, taking account of peculiar circumstances, which were important to McCulloch. He was sufficiently well informed of the facts to be relatively free from the "Ricardian Vice" '.

3 See McCulloch (1843: ix, 1995 [1849]: ix, and 1965 [1864]: xi).

4 O'Brien (1970) is the only comprehensive book on McCulloch. It includes an

extensive chapter on public finance. My chapter is much indebted to it, as well as his *Collected Works of J. R. McCulloch* (O'Brien 1995).

5 See also, McCulloch (1843: 547–58, 1995 [1849]: 594–5, and 1965 [1864]: 513).

6 See also McCulloch (1968 [1852]: 3 and 1975 [1863]: 16–17).

7 See also McCulloch (1968 [1852]: 18, 1995 [1860]: 40, and 1975 [1863]: 30).

8 The term 'inter-sectoral equality' is from O'Brien (1970: 234).

9 See also McCulloch (1968 [1852]: 9 and 1975 [1863]: 22).

10 See also McCulloch (1995 [1845]: 47, 1968 [1852]: 44, 1995 [1860]: 44, and 1975 [1863]: 55).

11 McCulloch's criticism of James Mill's scheme of a special tax on rent appeared also in the articles on taxation in the 6th and 7th editions of the *Encyclopaedia Britannica* (McCulloch 1824b: 11–12 and 1842: 101–2). However, in the 8th edition, probably in order to avoid going too far into a fictitious scheme, McCulloch eliminated all mention of Mill's plan (McCulloch 1995 [1860]: 43–5).

12 In the first edition of *Treatise on Taxation*, McCulloch quoted the following sentences from Ricardo's *Principles*: 'Rent often belongs to those who, after many years of toil, have realized their gains, and expended their fortunes in the purchase of land or houses; and it certainly would be an infringement of that security of property which should ever be held sacred, to subject it to unequal taxation' (Ricardo 1951–73 [1817], vol. 1: 204). McCulloch commented that '[w]e may, indeed, be assured that, in taxation, as in everything else, justice is the only safe policy, the permanent interest of all men and all communities' (1995 [1845]: 49).

13 See also McCulloch (1995 [1845]: 68, 1968 [1852]: 64, 1995 [1860]: 45, and 1975 [1863]: 64). Edgeworth (1897: 64–8) demonstrates that this conclusion needs the assumption of inelastic demand for houses. See also Shoup (1960: 101).

14 In the first edition of *Treatise on Taxation*, McCulloch proposed a progressive house tax (McCulloch 1995 [1845]: 69). However, in the second edition McCulloch withdrew this proposal (McCulloch 1968 [1852]: 64). In the 1860 *Encyclopaedia* article, he argued that the basic exemption from a house tax was unnecessary (McCulloch 1995 [1860]: 45). Thus, as time passed, McCulloch came to think that a house tax should be levied as proportionally as possible to the rent. McCulloch also regarded the window tax as an unobjectionable tax: see for example, McCulloch (1825a: 113, 1833a: 164, and 1833b: 437–8). However, after the commutation of the window tax for a new house tax in 1851, McCulloch did not support a revival of the window tax. For his favourable opinions of other assessed taxes see, for example, McCulloch (1995 [1845]: 267, 1968 [1852]: 274, and 1975 [1863]: 276–7).

15 According to O'Brien (1977: 209–10), before the 1852 budget, McCulloch advised Disraeli to lower the minimum exemption from the house tax, and reduce the malt duty, the hop duty, and the income tax on occupiers on land. Because Disraeli took this advice, the government fell. O'Brien (1977: 3) argues that '[w]hat he was in fact advising was a shift in the tax burden from the countryside to the towns'.

16 This passage was reproduced from an article in the *Scotsman* in 1823 (McCulloch 1823e: 713).

17 See also McCulloch (1995 [1845]: 102, 1968 [1852]: 72, 1995 [1860]: 46, and 1975 [1863]: 79).

18 In the first edition of *Treaties on Taxation*, McCulloch (1995 [1845]: 80) attached another condition, namely that demand for corn did not diminish in proportion to the increase in the price of corn.

19 According to O'Brien (1970: 314–19), after Nassau Senior's attack on Malthusianism in 1828, McCulloch abandoned the pessimistic Malthusian view that population pressure was always harmful to the progress of society.

20 Marshall (1998: 324) indicates that McCulloch preferred piece-rate systems, as well as high wages, because they would rescue workers from despair and the hardship of low living standards. See also Milgate (1994: 150–3).

21 McCulloch did not regard the standard of natural wages as physiologically fixed: 'The articles which are deemed necessaries, and the quantity of such articles required by the labourer, depend, in a great degree, on custom and habit, and are, in consequence, extremely variable' (McCulloch 1995 [1845]: 99).

22 Throughout his life, McCulloch maintained that a moderate indirect tax was more productive than an oppressive one. For example, see McCulloch (1820b: 186, 1822b: 516–36, 1824b: 31–6, 1842: 120–3, 1995 [1845]: 331–61, 1968 [1852]: 341–74, 1995 [1860]: 70–5, and 1975 [1863]: 341–71).

23 See McCulloch (1820c: 164, 1833a: 152, 1833b: 434, 1995 [1845]: 114–16, 1968 [1852]: 109–13, 1995 [1860]: 56, and 1975 [1863]: 110–14).

24 In contrast to J. S. Mill, McCulloch did not often differentiate between incomes according to whether they were inheritable or not. In a newly added paragraph in the second edition of *Treatise on Taxation*, McCulloch acknowledged that people with temporary (i.e. non-inheritable) incomes had to save a part of their income in order to make a fortune for their descendants, whereas people with perpetual (i.e. inheritable) incomes did not have to do so. However, McCulloch stated that an income tax levied in proportion to the capitalized value of income with respect to its duration took into account this difference (McCulloch 1968 [1852]: 125–6). In truth, such a tax did not differentiate between incomes according to the necessity of saving for a bequest. Probably recognizing this fact, McCulloch eliminated the whole paragraph in the third edition.

25 See McCulloch (1824b: 18–19, 1842: 108–9, 1995 [1845]: 141–3, 1968 [1852]: 139–41, 1995 [1860]: 52, and 1975 [1863]: 144–7).

26 This phrase was reproduced in the second edition of *Treatise on Taxation*, but eliminated in the third edition. Compare McCulloch (1968 [1852]: 136) and McCulloch (1975 [1863]: 142).

27 See McCulloch (1833a: 153–6, 1842: 106–7, 1995 [1845]: 125–30, 1968 [1852]: 120–5, 1995 [1860]: 50–1, and 1975 [1863]: 120–9).

28 In 1863, McCulloch recollected and regretted the introduction of the income tax: 'it may be doubted whether [the income tax] was so indispensable as has been generally supposed. Sir Robert Peel appears to have been impressed with the idea that we had reached the boundary of indirect taxation, and it was necessary to resort to direct taxes to redress the balance between revenue and expenditure. But we cannot help thinking that this was an entirely erroneous opinion' (McCulloch 1975 [1863]: 150).

29 O'Brien (1970: 378–95) indicates that McCulloch opposed the Corn Laws because of their harmful effect on price fluctuation and their danger to social order, rather than their negative effect on capital accumulation.

30 See also McCulloch (1968 [1852]: 171, 1995 [1860]: 58, and 1975 [1863]: 180).

31 See also McCulloch (1975 [1863]: 174).

32 In the article 'Taxation and the Corn-Laws', McCulloch emphasized that the interest of farmers was not consistent with that of landlords: 'It is landlords, and not farmers, who reap advantage from a high real price of corn, and from the cultivation of bad lands. The interest of the latter is precisely the same with the interest of the consumers; and, however paradoxical it may at first appear, it is unquestionably true that a *permanently* high price of raw produce is as certainly ruinous to the farmer as to the manufacturer' (McCulloch 1820b: 185; emphasis in original). However, later McCulloch abandoned this view, and argued that the clash of class interests did not exist in reality. See, for example, McCulloch (1834: 300–2).

33 In an article on tithes in the *Scotsman* in 1822, McCulloch proposed a commutation of tithes into a fixed – not proportional – tax on the rent of land (McCulloch 1822c: 312).
34 See also McCulloch (1824b: 25–7).
35 Whereas Ricardo proposed a duty of 10 shillings a quarter, McCulloch claimed that, without tithes, it could be reduced to 3 or 4 shillings (McCulloch 1823a: 546). In the 1826 *Edinburgh Review* article, McCulloch put forward a fixed countervailing duty of 5 or 6 shillings per quarter, although he thought that the agriculturists could only claim an *ad valorem* duty of 1 or 2 per cent (McCulloch 1826b: 356).
36 For example, see McCulloch (1842: 113, 1995 [1845]: 176, 1968 [1852]: 180, 1995 [1860]: 63, and 1975 [1863]: 186–7).
37 See also McCulloch (1843: 163, 1995 [1845]: 223, 1968 [1852]: 229, 1995 [1860]: 62, and 1975 [1863]: 224).
38 In the 1860 *Encyclopaedia* article, considering the political difficulty of reimposing the duties which had been abolished, McCulloch considered an increase in the rates of existing duties: 'The custom duties that are still in existence might . . . be increased so as to produce a large additional revenue. . . . Such increase will, however, be a much more difficult matter now, when there are but few articles subject to duties, than when they were comparatively numerous. But, despite this disadvantage, it will probably be found, in the event of any considerable increase of revenue being required, that it may be better raised by judicious changes in the duties of customs and excise, than by any other means hitherto suggested' (McCulloch 1995 [1860]: 62). However, McCulloch abandoned this scheme, probably because Gladstone's tariff reform in 1860 radically reduced the number of articles subject to customs duties.
39 O'Brien (1970: 226) argues that 'McCulloch was by no means an extreme and unconditional free trader'. For McCulloch's trade theory, see O'Brien (1970: 191–228).
40 Realty (or real property) meant land and rights attached to the possession of land. Personalty (or personal property) meant all property except land and those rights in land.
41 John Austin – one of the Philosophic Radicals – contributed a critical review of McCulloch's article to the *Westminster Review*, started by James Mill in the same year. Austin wrote: 'It is clear . . . that if [McCulloch's] principles were pursued to their legitimate consequences, the middling sort of people would nearly disappear, and society would be pretty distinctly divided into two classes: a few rich, and many poor. It is equally clear . . . that there would be less of industry and frugality, and, by consequence, less of wealth, than if wealth were less unequally distributed' (Austin 1824: 511).
42 In this pamphlet, McCulloch emphasized the necessity of aristocracy: 'A powerful and widely ramified aristocracy, like that of England, not resting for support on any oppressive laws, and enjoying no privileges but which are for the public advantage, is necessary to give stability and security to the government, and freedom to the people. And our laws in regard to succession being well fitted to maintain such an aristocracy, and, at the same time, to inspire every other class with the full spirit of industry and enterprise, to change them would not be foolish merely but criminal' (McCulloch 1848: 172). It must be noted that in 1848 the last great burst of Chartism occurred in Britain, and revolution on the Continent. According to O'Brien (1977: 212), McCulloch had feared revolution since the 1830s. See also O'Brien (1970: 101).
43 For a discussion of inheritance tax reform in the second half of the nineteenth century see, for example, Daunton (2001: 224–55).
44 See also McCulloch (1968 [1852]: 298 and 1995 [1860]: 67).

45 See also McCulloch (1975 [1863]: 296–7).

46 Before the 1853 reform, McCulloch proposed reducing or abolishing the probate and administration duties because of their regressive nature. In contrast, after the reform, probably considering the failure of the succession duty to raise sufficient revenue, McCulloch proposed an extension of those duties to all kinds of property. Compare McCulloch (1995 [1845]: 296 and 1968 [1852]: 305–6) with McCulloch (1975 [1863]: 297). In 1881, Gladstone reformed the probate duty, making it a nearly proportional duty at 3 per cent.

47 See also McCulloch (1995 [1828a]: 61, 1828b: 570–1, 1968 [1852]: 422, and 1975 [1863]: 412). Before 1828, McCulloch was more sympathetic to a lump sum tax than public debt as a revenue-raising measure: see, for example McCulloch (1823d: 9–10).

48 McCulloch argued: ‘there does not seem to be much doubt that an income-tax of 10 or 12 per cent. might have been levied during the American war: and . . . it may be doubted whether, had an income-tax of that amount been imposed in 1793, it would have been so injurious as the great additions that were then made to the customs and excise duties; while, by providing a large additional revenue, it would have obviated the necessity of funding’ (McCulloch 1995 [1845]: 418). See also McCulloch (1995 [1828a]: 84, 1968 [1852]: 433, and 1975 [1863]: 422).

49 See also McCulloch (1968 [1852]: 441 and 1975 [1863]: 430).

50 McCulloch credited this scheme to Malthus’s *Grounds of an Opinion on the Policy of Restricting the Importation of Foreign Corn*. For Malthus’s argument, see Section 5.3.2, page 103. However, whereas Malthus discussed an increase in the real burden of the interest payment on public debt in order to defend the Corn Laws, McCulloch used Malthus’s argument to abolish the laws. See O’Brien (1995, vol. 1: ix–xxxi).

51 McCulloch argued: ‘The practical question we shall most probably be first called upon to decide, is, not what are the best and most advantageous means by which a part of the public debt may be paid off, but what is the least injurious method of increasing it’ (McCulloch 1995 [1828a]: 60). McCulloch proposed to modify the existing mode of funding – in which bonds were sold by the government at a price below par – into the mode in which they were sold at par and at a higher rate of interest. McCulloch believed that this modification would prevent the government from repaying the larger amount of money than it had borrowed (McCulloch 1995 [1828a]: 84–85).

52 Later McCulloch commented on Ricardo’s ‘Funding system’: ‘This tract . . . is the least valuable of his publications, being incomplete, confused in its arrangement, and in all respects unsatisfactory’ (McCulloch 1995 [1859]: 558).

53 See, for example, McCulloch (1816b: 206–12, 1819a: 165, 1823d: 31–7, 1995 [1845]: 449–63, 1968 [1852]: 462–74, and 1975 [1863]: 450–61).

54 See also McCulloch (1968 [1852]: 477).

55 See also McCulloch (1843: 548, 1995 [1849]: 595, and 1965 [1864]: 513).

8 John Stuart Mill

8.1 Introduction

Although John Stuart Mill adopted Ricardo's political economy – as well as Bentham's utilitarianism and James Mill's philosophic radicalism – he was critical of its assumption of the permanence of class society. In the article 'Miss Martineau's summary of political economy' (1834), Mill argued:

> [Ricardian political economists] revolve in their eternal circle of landlords, capitalists, and labourers, until they seem to think of the distinction of society into those three classes, as if it were one of God's ordinances, not man's, and as little under human control as the division of day and night. Scarcely any one of them seems to have proposed to himself as a subject of inquiry, what changes the relations of those classes to one another are likely to undergo in the progress of society; to what extent the distinction itself admits of being beneficially modified, and if it does not even, in a certain sense, tend gradually to disappear.
>
> (Mill 1963–91 [1834a], vol. 4: 226–7)

In contrast to Ricardo, Mill thought that, whereas the law of production was subject to natural circumstances, the law of distribution was a human institution. The government could influence the law of distribution by economic and social policies. In order for British society to move towards a more equitable state, it had to remove several institutional obstacles. Mill considered that the present system of public finance was one of the main obstacles:

> society has many incumbrances to throw off, before it can start fair on that new journey. We have to abolish all monopolies, and restrictions on trade or production for the benefit of particular classes; *to pay off our debt by an impost in all kinds of property; to new-model our whole fiscal system, with a view to raise no more revenue than is necessary, to raise it in the least costly manner, and to avoid favouring any class of contributors at the expense of another.*
>
> (Mill 1963–91 [1834a], vol. 4: 227; emphasis added)

Mill indicated his basic idea of tax reform in two articles in 1833: 'Necessity of revising the present system of taxation' and 'Errors and truths on a property tax'. Mill continued to put forward tax reform plans until the end of his life: for example, in his *Principles of Political Economy* (1848; henceforth *Principles*); before the Select Committees on Income and Property Tax in 1852 and 1861; and in the Land Tenure Reform Association which he chaired in the 1870s.

In this chapter, I will reconstruct Mill's works on fiscal reform. The following section will outline his views on the role of government and its expenditure. Mill's tax reform proposals will be divided into two kinds of programmes – the equal-sacrifice programme; and the restoration programme.[1] The third section will examine the equal-sacrifice programme, which is composed of an income tax, a house tax, and taxes on luxuries. In the fourth section, inheritance taxes and a land tax will be discussed as key parts of the restoration programme. The fifth section discusses Mill's views on the issue and extinction of public debt. This chapter will conclude that Mill's reform programmes concerning public finance were consistent with the long-term purpose of his economic and social policies, namely preparation for a more equitable society.[2]

8.2 The role of government and the effects of government expenditure

In Book 5 of the *Principles*, Mill discussed the economic role of government in detail. Mill did not accept the dogmatic laissez-faire principle that the role of government should be strictly limited to protection against force and fraud. Mill adopted the utilitarian principle of legislation that general expediency – namely, the total utility of the community – was the sole universal principle which could judge the functions of government.[3] Moreover, Mill distinguished between the necessary and optional functions of government. The necessary functions included the functions 'which are either inseparable from the idea of a government, or are exercised habitually and without objection by all governments' (Mill 1963–91 [1848], vol. 3: 804). These were: (1) the means adopted by governments to raise the revenue which is the condition of their existence; (2) the laws which they prescribe on the two great subjects of property and contracts; and (3) the system of means by which they enforce the execution of their laws, namely, their judicature and police. The necessary functions of government concerned the security of property and contracts, as well as public finance.

The optional functions were defined as those 'that the expediency of its exercising them does not amount to necessity, and is a subject on which diversity of opinion does or may exist' (Mill 1963–91 [1848], vol. 3: 804). As examples, Mill gave: (1) education; (2) protection of children and young persons; (3) perpetual contracts between people (for example, marriage); (4) monopolistic services (for example, gas, water, road, canal, and railway); (5) working hours; (6) poor relief; (7) colonization; (8) scientific discoveries; and (9) services wanting private agency (Mill 1963–91 [1848], vol. 3: 936–71). As examples of optional functions grounded on erroneous theories, Mill indicated: (1) protection of domestic industries; (2) usury laws; (3) price regulations; (4) monopolies or restrictions of competition; (5) laws against combination of workmen; and (6) restraints on opinion or on its publication (Mill 1963–91 [1848], vol. 3: 913–35).

In contrast to Ricardo, Mill did not consider too seriously the suggestion that government expenditure would prevent capital accumulation. Mill believed government expenditure was unproductive, and that, if it was financed by public debt, it would remove private capital. However, in a wealthy country – like Britain – where there was an excess of capital available for export to foreign countries, a reduction of capital would not influence the national welfare. Thus, Mill concluded that 'this view of things greatly weakens . . . the force of the economical argument against the expenditure of public money for really valuable, even though industriously unproductive, purposes' (Mill 1963–91 [1848], vol. 3: 748).[4]

Although Mill accepted a wide range of governmental functions, and denied that government expenditure would always disturb economic growth, he did not positively propose an increase in government expenditure. In the last paragraph of the *Principles*, Mill argued:

> I have not thought it necessary here to insist on that part of the functions of government which all admit to be indispensable, the function of prohibiting and punishing such conduct on the part of individuals in the exercise of their freedom, as is clearly injurious to other persons, whether the case be one of force, fraud, or negligence. . . . It is the proper end of government to reduce this wretched waste to the smallest possible amount, by taking such measures as shall cause the energies now spent by mankind in injuring one another, or in protecting themselves against injury, to be turned to the legitimate employment of the human faculties, that of compelling the powers of nature to be more and more subservient to physical and moral good.
>
> (Mill 1963–91 [1848], vol. 3: 971)

Mill thought that government expenditure on protection against force and fraud should be reduced, and that the reduction should be used in order to increase national welfare. Mill's proposal to give more weight on civil government was consistent with what was actually happening in the middle of the nineteenth century (see Figure 1.3, page 7).

8.3 The equal-sacrifice programme

8.3.1 Income tax

8.3.1.1 Early Mill

Mill's early statements concerning an income tax are found in his two articles in 1833. Mill argued that the existing taxation system in Britain suffered from inequality and inefficiency: the window tax, the house tax, and the tax on probates of wills, spared the rich by stopping at a certain maximum; the stamp duty did not rise in proportion to the amount of the sum paid; the legacy duty was not imposed on land; taxes on necessities such as the tax on foreign corn and the tax on raw cotton imposed heavier burdens on the poor than the rich; the excise duties interfered with the best and cheapest processes of production by vexatious and burdensome regulations on the producers and dealers; custom duties made a loss by protecting home and colonial industry. Thus, following Henry Parnell, Mill thought that the British taxation system had to be fundamentally reformed (Mill 1963–91 [1833a], vol. 23: 545–8 and 1963–91 [1833b], vol. 23: 549–54).

In order to effect these tax reforms – in particular, the reduction or abolition of customs and excise duties – Mill insisted on reintroducing an income tax. Mill did not support the imposition of a direct tax on property income alone: for example, he opposed Lord Althorp's proposal for a tax on the transfer of stock (Mill 1963–91 [1831], vol. 22: 263–9); and criticized the *Times* which supported a property tax imposed solely on landholders and fundholders (Mill 1963–91 [1833c], vol. 23: 566–8). It would be unfair to allow incomes from intangible capital to remain untaxed, for example those of professionals such as lawyers and physicians. In order for a direct tax to be a general tax, it should be imposed on all kinds of property including intangible capital.

Like all other writers on taxation in the nineteenth century, Mill discussed two technical problems with an income tax: differentiation and graduation. Mill differed from his father concerning the differentiation of incomes. James Mill thought that an income tax had to be imposed at a uniform rate on the capitalized value of every income, independently of its source and duration.[5] For example, a land-rent of £100 paid for 30 years, and salaries of £500 paid for 6 years, were regarded as having an equal capitalized value – £3,000. The annual income was calculated by multiplying the capitalized value by the rate of interest, for example 5 per cent: it would become £150. If an income tax of 10 per cent was imposed on the calculated annual income, both incomes would have to pay £15 for a definite period. The proportion of the annual tax payment occupied in nominal annual income would be different for each: 15 per cent for the land rent; 3 per cent for the salaries. This result stemmed from the difference in the duration of income.[6] James Mill believed that this type of income tax alone could be consistent with the traditional maxim of equality; it would 'leave the relative condition of the different classes of contributors the same after the tax as before it' (Mill 1824: 268).

The younger Mill admitted the numerical correctness of his father's argument. However, Mill thought that an income tax at a uniform rate was incorrect 'if we consider what is alone of any importance, equality of pressure upon the feelings of individuals' (Mill 1963–91 [1833b], vol. 23: 550). Mill thought that people who earned temporary or precarious incomes – for example, salaries or business income, respectively – had to save their income in order not only to provide for their old age, but also to form an inheritance for their descendants. By contrast, people who earned permanent and certain incomes – for example, from the rent of land – could spend their income with less anxiety about their own and their children's future. Considering the pressure of saving on one's feelings, Mill proposed that some portion of temporary and precarious incomes should enjoy a special differentiation extending beyond their duration.[7] Thus, Bentham's exemption rule with respect to precarious and temporary incomes was adopted. Mill also followed Bentham in thinking that the part of any income necessary to satisfy the physical wants of human beings ought to be exempted from taxation. Consequently, the income tax which Mill considered was a tax imposed on surplus spending – the remainder of income from which subsistence income and savings were subtracted.[8]

Mill suggested that a proportional tax should be imposed on surplus spending. Although the exemption of subsistence income would make the tax graduated, Mill supported this type of graduation. However, Mill did not accept the imposition of a graduated tax on surplus spending:

> If the tax spares actual necessaries, the maxim [of graduation] no longer holds: beyond that point it is scarcely true that numerical equality is real inequality. One-tenth of each man's *superfluities* would seem to be no heavier tax on one man than on another, whatever may be the difference in their fortunes.
>
> (Mill 1963–91 [1833b], vol. 23: 553; emphasis in original)

Thus, although Mill abandoned the traditional maxim of equality – the principle of distribution neutrality – he did not adopt the graduated tax scheme proposed by other Radicals.[9] Mill believed that a proportional tax on surplus spending alone was consistent with his maxim of equality: 'equal taxation consists not in taking equal proportions from the *incomes* of individuals, but in taking equal proportions from their *enjoyments*' (Mill 1963–91 [1833b], vol. 23: 552; emphasis in original). Let us call this maxim 'the principle of equal sacrifice of enjoyment'. Mill maintained this principle throughout his discussions of income tax.

8.3.1.2 The first edition of the Principles *(1848)*

Mill set out his overall theory of taxation in the *Principles*. Although Mill adopted Smith's four maxims of taxation – equality, certainty, convenience, and economy – he thought that the concept of equality ought to be defined more precisely:

> The last three of these four maxims [i.e. certainty, convenience, and economy] require little other explanation or illustration than is contained in the passage itself. . . . But the first of the four points, equality of taxation, requires to be more fully examined, being a thing often imperfectly understood, and on which many false notions have become to a certain degree accredited, through the absence of any definite principles of judgement in the popular mind.
>
> (Mill 1963–91 [1848], vol. 3: 806)

To Mill, equality meant 'apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his' (Mill 1963–91 [1848], vol. 3: 807). A proportional tax on surplus spending would best satisfy this definition of equality.

Mill generally followed Ricardo's theory of tax incidence. Taxes on profits, wages, agricultural produce, and necessities, would fall on profits, whereas taxes on the rent of land would fall on rent itself. However, these results held true only in a short-run theory of tax incidence. Mill transformed the Ricardian theory of tax incidence into a long-run theory. For example, Mill argued that the burden of taxes falling on profits would partly be carried by labourers and landlords, because such taxes would shorten the time which the economy would take to reach a stationary state. Because of the taxes, labourers and landlords would lose future income which they would have obtained. The long-run theory of tax incidence signified that 'the effects of a tax on profits are much more complex, more various, and in some points more uncertain, than writers on the subject have commonly supposed' (Mill 1963–91 [1848], vol. 3: 828).[10] If the economy was already in a stationary state and the rate of profit was at a minimum, the national capital would be reduced because of those taxes. Thus, Mill concluded that taxes on profits were 'extremely detrimental to the national wealth' (Mill 1963–91 [1848], vol. 3: 828).

Mill also applied the long-run theory of tax incidence to the abolition of the Corn Laws in 1846. The protecting duty on the importation of corn had kept the rent of land and the price of corn high, prevented the efficient use of capital and labour, and consequently checked economic growth. If the law had not been abolished, the British economy would have reached a stationary state earlier: consequently the total amount of capital and labour employed in a stationary state would have been less.

Thus, the burden of the duty had been incurred not only by capitalists and consumers but also by labourers. Because of the abolition of the Corn Laws, the time in which the economy could continue to grow would be prolonged, and the total amount of capital and labour employed in the process of growth would increase (Mill 1963–91 [1848], vol. 3: 849–50).

In the *Principles*, while explaining and extending the Ricardian theory of tax incidence, Mill argued for something to which Ricardo had rarely referred, a general income tax. Mill maintained the view which he had put forward in the 1830s: that subsistence income and savings should be exempted from taxation; and that the tax should be levied proportionally on surplus spending.

Mill rejected imposing a graduated tax on income above the subsistence level. Such a tax could have been justified if it had been proved that the poor's marginal utility of income was always larger than that of the rich. However, Mill argued that 'this doctrine seems to me too disputable altogether, and even if true at all, not true to a sufficient extent, to be made the foundation of any rule of taxation' (Mill 1963–91 [1848], vol. 3: 810). It would be practically impossible to measure the difference in marginal utility of income between different individuals. In the third edition of the *Principles* (1852), Mill wrote more clearly:

> Whether the person with 10,000*l.* a year cares less for 1000*l.* than the person with only 1000*l.* a year cares 100*l.*, and if so, how much less, does not appear to me capable of being decided with the degree of certainty on which a legislator or a financier ought to act.
>
> (Mill 1963–91 [1848], vol. 3: 810)

Thus, Mill used neither the law of diminishing marginal utility nor interpersonal comparisons of utility as foundations of his discussion.

A graduated tax would become a penalty on industry: 'To tax the larger incomes at a higher percentage than the smaller, is to lay a tax on industry and economy; to impose a penalty on people for having worked harder and saved more than their neighbours' (Mill 1963–91 [1848], vol. 3: 810–11). Mill claimed that a just and prudent legislation would avoid an arbitrary and penalizing tax.

With regard to differentiation, Mill indicated that the first and best way was to exempt the amount which was really saved.[11] If this could be done, such an income tax could be more suitably called 'an expenditure tax'.[12] In fact, however, it was difficult to capture individual savings as they could take various forms. The second best way was to exempt from taxation the portion of income that was expected to be saved. For this purpose Mill proposed to impose an equal tax rate on 75 per cent of surplus income if it was temporary income, and on 100 per cent of it if it was permanent income.

In fact, however, Peel's income tax – introduced in 1842 – did not adopt such a system. Mill criticized the tax:

> The existing tax treats all kinds of incomes exactly alike, taking sevenpence in the pound, as well from the person whose income dies with him, as from the landowner, stockholder, or mortgagee, who can transmit his fortune undiminished to his descendants. This is a visible injustice.
>
> (Mill 1963–91 [1848], vol. 3: 813)

Moreover, because the income tax was often evaded by false statements, it fell most heavily on the most conscientious. Seeing the reality of the income tax, Mill lost the previous zeal for the support of it:

> This consideration [of tax evasion] would lead us to concur in the opinion which, until of late, has usually prevailed – that direct taxes on income should be reserved as an extraordinary resource for great national emergencies, in which the necessity of a large additional revenue overrules all minor objections.
>
> (Mill 1963–91 [1848], vol. 3: 832)

Probably because a number of oppressive customs and excises duties had been abolished or reduced, Mill became more sympathetic to taxes on commodities.[13] In Chapter 6, 'Comparison between Direct and Indirect Taxation', Mill gave his views on the balance between direct and indirect taxes, as well as the role of an income tax:

> With [a land tax, an inheritance tax], and a house tax of suitable amount, we should, I think, have reached the prudent limits of direct taxation, save in a national emergency so urgent as to justify the government in disregarding the inequality and unfairness inseparable from every practicable form of income tax. The remainder of the revenue would have to be provided by taxes on consumption.
>
> (Mill 1963–91 [1848], vol. 3: 868)

Thus, Mill insisted that a majority of public revenue had to be raised – as it always had been – by taxes on commodities, rather than direct taxes, and that an income tax should be reserved against a national emergency. However, Mill did not propose abolishing the existing income tax. Instead, Mill insisted on making it fair by exempting savings.

8.3.1.3 The Hume Committee (1851–2)

In 1852, Mill gave evidence before the Select Committee on Income and Property Tax, chaired by Joseph Hume, a Radical MP. The committee's main focus was on the problem of whether tax rates should be differentiated between different forms of income.[14] To the committee, Mill proposed a two-step distinction for exempting savings from income tax: first, a distinction between permanent and temporary incomes; second, a distinction between certain and precarious incomes. The portion of temporary-and-certain incomes – for example, salaries – presumed to be saved should be exempted from taxation. Temporary-and-precarious incomes – for example, professional incomes and business incomes – should enjoy a further exemption. For example, let the tax rate be 10 per cent, and subsistence income be £100. Income of £900, if it derived from a rent of land, was liable to an income tax of £80. If income of the same amount derived from a salary, and if the average propensity to save was equal to one-fourth, the tax would be imposed on £600, and consequently £60 had to be paid. If income of £900 was professional income or business income, the tax could be reduced, for example, to £50 (Mill 1963–91 [1852], vol. 5: 468–71).

In order to reinforce his insistence on exempting savings from the income tax, Mill indicated a problem of double taxation on savings and interest (see Mill 1963–91 [1852], vol. 5: 476). Let the tax rate and the interest rate be 10 per cent. A man who earned income of £100 – let the exemption for subsistence income be ignored – had to pay tax of £10. Consequently, he could spend £90 on enjoyments during this year. If he saved £90, he would receive interest of £9 in the following year. The income tax would be imposed on his interest of £9: he would have to pay 90 pence. Consequently he could spend only £98.1 in the second year: its discounted present value was approximately equal to £89.2, less than the £90 which he could have spent in the first year. Thus, the principle of equal sacrifice of enjoyment was violated by the double taxation of savings and interest. In order to equalize the present value of spending between the two cases, £9 of interest in the second year had to be untaxed, or a tax had to be imposed only when income was expended – not when income was earned.[15]

Mill's explanation of double taxation was consistent as long as income was defined only as 'a flow of physic enjoyment or satisfaction' (Fisher 1930: 453). However, if income was regarded as a return on productive activities, Mill's argument was simply fallacious. It confused two different productive cycles: the one which produced the saved income; and the other one which produced new income, namely the interest.[16] Moreover, if interest on present and future savings had to be exempted from an income tax, all incomes derived from property – past savings – had to be untaxed as well. Mill's argument concerning double taxation undermined his income tax scheme on the basis of the equal-sacrifice principle.

Because witnesses' opinions on the income tax were so diverse and conflicting, the Hume Committee's Report simply presented its evidence to Parliament, without any recommendations. In 1853, Gladstone, Chancellor of the Exchequer, began a programme of tariff reform. A number of customs and excise duties were abolished or reduced, and a succession duty which targeted landed property was introduced. Gladstone stated that he would reduce the income tax gradually and abolish it in seven years. However, Gladstone also announced that, until the end of the income tax, he would keep the present system. Thus, Mill's proposal of the two-step-differentiation did not come to fruition.

In the 1850s, Mill published the third (1852) and the fourth (1857) editions of the *Principles*. Major revisions concerning an income tax were made in the third edition. For example, Mill added new sentences on the problem of double taxation on savings and interest (Mill 1963–91 [1848], vol. 3: 815–16), and the two-step distinction (Mill 1963–91 [1848], vol. 3: 816–17 and 818–19). Mill also moved to a footnote the sentences which had suggested the possibility of capturing individual savings (Mill 1963–91 [1848], vol. 3: 818n). In order to criticize the progressive income tax, Mill demonstrated the unreliability of interpersonal comparisons of utility (Mill 1963–91 [1848], vol. 3: 810). Thus, Mill revised the statements concerning an income tax in the *Principles* on the basis of his evidence before the 1851–2 committee.[17]

8.3.1.4 The Hubbard Committee (1861)

Gladstone's promise to abolish the income tax in 1860 was not honoured, because government expenditure – particularly military and naval – increased more than expected, and because the new succession duty failed to raise as large a revenue as expected. Although Gladstone emphasized that he did not give up hope for the future abolition of the income tax, the prolonged reliance on it signified that the tax might be permanent. The present system – which had been introduced only as a temporary measure – had to be reconsidered so that it could be fit for long-term use. Thus, the Select Committee on Income and Property Tax was set up in 1861. It was chaired by J. G. Hubbard – a strong advocate of differentiation. Hubbard proposed that one-third of income could be exempted from tax if it belonged to industrial incomes, namely profits from mining adventures, farms, manufacture, trade, shipping business, and professions, as well as salaries and stipends. By contrast, this exemption rule was not applied to spontaneous incomes such as the rents of land and houses, interest from public and private securities, and pensions.[18]

Mill was again one of the witnesses. In the committee, Mill did not alter his fundamental opinions with respect to the income tax from those of 1852, although he had 'more of an opinion upon some points of practical execution' (Mill 1963–91 [1861], vol. 5: 598). Mill approved Hubbard's exemption rule for the income tax.[19] In fact, Hubbard's concept of industrial income was generally consistent with Mill's ideas on temporary and precarious incomes. However, Mill argued that recipients of pensions, clergymen, and holders of tithe rent-charges – whom Hubbard classified as enjoying spontaneous income – could receive the one-third exemption from the income tax because they had to save some portion of their income.[20]

The most important difference between Mill's 1861 and 1852 evidence was that in 1861 Mill demonstrated professional income should be exempted from taxation to a greater degree than business income: in his 1852 evidence, both were treated equally as temporary-and-precarious income. Mill thought that the necessity or obligation of savings was greater in the case of professional men than in the case of traders because, whereas traders had tangible capital and business abilities which could be left to their children, professional men did not usually have such inheritable capital (Mill 1963–91 [1861], vol. 5: 560–1 and 580).

Consequently, with respect to the exemption rule, Mill gave the following order of priority to incomes: (1) temporary-and-precarious income obtained without inheritable capital, typically professional income; (2) temporary-and-precarious income earned with inheritable capital, that is, business income; (3) temporary-and-certain income without inheritable property, such as salaries and pensions; (4) temporary-and-certain income with inheritable property (including widow's jointure); (5) permanent income, typically the rent of land. This order of priority with respect to tax exemption can be regarded as the work which Bentham gave up as 'endless labour' (Bentham, 1962 [1795–6a], vol. 2: 518; see Section 4.2.4, page 76). It must be stressed that Mill gave this order of priority, not for the purpose of favouring a specific class, but on the basis of the equal-sacrifice principle.

However, Mill's order of priority was not consistent with the principle that savings should be exempted from the income tax: in fact, the permanent income class could be the class with the highest level of savings. Moreover, his proposal contradicted the logical consequence of his argument on double taxation: incomes derived from inheritable property – past savings – had to be untaxed. Finally, the above exemption rule would produce an obvious inequality: for example, a rich professional would enjoy a lower rate of income tax, while a poor landlord would suffer from a higher tax rate. Mill's and Hubbard's plan for differentiation had theoretical, as well as practical, difficulties. They failed to persuade Gladstone and his followers, who wished to keep the existing system of income tax. Hubbard's proposal was rejected by the committee, and consequently Gladstone could shelve the income tax reform.[21]

After the 1861 committee, Mill revised the *Principles* for the fifth edition (1862) on the basis of his evidence. Mill answered more precisely the questions asked in the committee. However, Mill did not resolve the contradictions in his exemption rule plan.[22]

8.3.1.5 Mill's last years

In 1865, Mill became a member of the House of Commons, and proposed political, social, and economic reforms. However, when it came to the income tax reform, Mill only occasionally repeated his previous opinion (Robson 1963–91, vol. 16: 1032, 1221, 1339, 1477, and vol. 28: 69–73). In the latter half of the 1860s, Mill shifted his concern from the income tax to inheritance taxes and the land tax. In the 1870s, as the Chair of the Land Tenure Reform Association, Mill devoted his attention to introducing a tax on the natural increase in the value of land. Mill's final reference to an income tax was made in his comment on Constantine Baer's book:

> The many injustices of a direct income-tax are generally acknowledged; while perhaps the greatest of all is that which is the least complained of, that it is a tax on conscience, and a premium on deception and improbity. . . . Nevertheless, an income-tax is felt to be indispensable on our present financial system, because without it there are actually no means, recognised by existing opinion, of making the richer classes pay their just share of taxation – a thing which cannot be done by any system of taxes on consumption yet devised.
>
> (Mill 1963–91 [1873b], vol. 5: 701–2)

Thus, Mill acknowledged that income tax was indispensable to the British system of public finance, and that the object of the tax was in 'making the richer class pay their just share of taxation'.[23] However, this statement should be interpreted as correcting the inequality of the burden in the existing system of taxation rather than redistributing income or diffusing property between the rich and the poor. If equalizing income distribution had been the true object of an income tax, Mill could have proposed a progressive tax on surplus spending; but he maintained his opinion that such a tax was a penalty on industry and economy.[24]

If the object had been to diffuse property among people, Mill could have supported a direct tax imposed on property alone; but he thought that such a measure 'is certainly the reverse of expedient, & is not just on any principles but those of Proudon' (Robson 1963–91, vol. 17: 1859).[25] Mill's proposal to exempt subsistence income from the income tax was applied not only to the poor but also to all other classes. Mill always preferred a system of income tax which could prevent tax evasion in particular by the middle class. Thus, with respect to the income tax policy, Mill had no bias for – or against – a specific class, and maintained the principle of equal sacrifice of enjoyment. We should believe his utterance before the 1861 committee that 'I beg to be understood as speaking positively only on the claims of justice, and the scientific principle on which the tax should rest' (Mill 1963–91 [1861], vol. 5: 554).

8.3.2 House tax

Mill thought that a house tax was better than the income tax, or was the best form of income tax, because a house tax – if assessed impartially – could exempt savings automatically. Mill held this opinion from the early 1830s. In his note on newspapers, 'Lord Althorn's budget', Mill stated that 'a house-tax . . . realizes far more perfectly than an income-tax, the perfection of an income tax itself, – that of being proportioned not to what a man has, but to what he can afford to spend' (Mill 1963–91 [1834b], vol. 6: 162).

However, a house tax had the characteristic of being a special tax on land. In the *Principles*, Mill analyzed this property on the basis of the incidence of a house tax (Mill 1963–91 [1848], vol. 3: 833–7). Following Smith and Ricardo, Mill assumed that the total rent of a house was composed of a building rent and a ground rent. Mill argued that the portion of the tax which fell on the building rent would finally be incurred by the tenant, because the owner would shift the tax to the building rent in order to prevent the rate of profit on the building cost from falling below the average level.[26]

A portion of the tax which fell on the ground rent would be paid by both the tenant and the landowner. Mill divided ground rent into two kinds: a differential rent attributable to location or circumstances; and a rent paid to prevent the land from being transferred into other uses, for example, agriculture – this payment could be called 'a transfer-preventing rent'. Because tenants always had to pay a fixed amount of a transfer-preventing rent per acre, they had to pay the tax which fell on it. By contrast, a house tax on the differential rent – an excess amount over the transfer-preventing rent – would be paid by the landowner. Consequently, the portion of a tax which fell on the building rent and the transfer-preventing rent was finally paid by the tenant: thus it acted as an expenditure tax. By contrast, the portion which fell on the differential rent would be paid by the landowner, and consequently constituted a special tax on the land tenure: this result contradicted Mill's claim that a house tax was a general and fair tax.

Mill dealt with this problem as follows. In the countryside, because the landowner usually received only a small portion of the house rent, a house tax would rarely fall on him. Hence, the degree as a special tax on the land tenure would be negligible. In contrast, in a town, the great portion of a house rent was paid to the owner of the land. However, Mill thought such unearned income a fit subject for a special tax: 'So far therefore as a house-tax falls on the ground-landlord, it is liable to no valid objection' (Mill 1963–91 [1848], vol. 3: 835).[27]

Because minimum spending would be exempted, the portion of the house tax which fell on the tenant would be proportioned to his surplus spending on houses. This was consistent with the principle of equal sacrifice of enjoyment. Mill concluded:

> In so far as it falls on the occupier, if justly proportioned to the value of the house, it is one of the fairest and most unobjectionable of all taxes. No part of a person's expenditure is a better criterion of his means, or bears, on the whole, more nearly the same proportion to them. A house-tax is a nearer approach to a fair income tax, than a direct assessment on income can easily be; having the great advantage, that it makes spontaneously all the allowances which it is so difficult to make, and so impracticable to make exactly, in assessing an income tax.
>
> (Mill 1963–91 [1848], vol. 3: 835–6)

Mill continued to entertain his favourable opinion of a house tax after the first edition of the *Principles*.[28]

8.3.3 Taxes on luxuries

As has been shown in Section 8.3.1.2 of this chapter (page 180), Mill considered that the majority of the public revenue had to be raised by indirect taxes. Even in the 1830s, when he insisted on the abolition of oppressive customs and excise duties, arguing that they would distort economic activity and impose heavier burdens on the poor, Mill suggested the retention of indirect taxes on luxuries. Mill thought that a poor man who was exempt from income tax had to pay indirect taxes if he spent his income on luxuries. Similarly, a man who earned temporary or precarious income had to contribute to the public revenue, if he spent money on luxuries using the part of his income which was exempted from an income tax on the presumption that it would be saved (Mill 1963–91 [1833b], vol. 23: 554).

Mill's support for indirect taxes on luxuries strengthened after income tax was reintroduced in 1842. Mill was disappointed, because it was far from his ideal tax, namely an expenditure tax. Moreover, Mill was displeased by the fact that the income tax was often evaded, particularly by people of Schedule D – the industrial-income class. Mill thought that because a higher rate of income tax would promote evasion, government revenue had to rely on indirect taxes.[29] The question was 'which of [indirect taxes] are the least objectionable' (Mill 1963–91 [1848], vol. 3: 868).

Mill listed seven practical rules for desirable indirect taxes: (1) to impose taxes on luxuries; (2) to make the consumer – not the producer – pay the tax; (3) to choose luxuries which were widely consumed; (4) to minimize the number of commodities taxed; (5) to tax stimulants first; (6) to confine taxes – if possible – to imported articles which were not produced in the country; and (7) to restrict the tax rate in order to prevent evasion and smuggling (Mill 1963–91 [1848], vol. 3: 870–1). These were consistent with the principles which Gladstone adopted in his tariff reform.

Mill regarded taxes on such luxuries as spirits, tea, coffee, sugar, beer, wine, and tobacco as the least objectionable. It must be noted that these commodities were consumed by the lower income groups, as well as the middle and upper income groups.[30] In order to lighten the burden of those on lower incomes, the tax rate on these commodities had to be kept low. Mill believed that taxes on spirits and tobacco could be reduced without producing a reduction of tax revenue. No tax should be imposed on necessities: if taxes were imposed on necessities, the exemption limit of the income tax had to be increased in order to compensate for those indirect taxes (Mill 1963–91 [1848], vol. 3: 809, 1963–91 [1852], vol. 5: 473, and Robson 1963–91, vol. 16: 1477).

In his later years, Mill continued to support the retention of taxes on luxuries, because they could capture the spending of those who evaded income tax, and would keep the rate of income tax low. In a letter to Leslie on 1 December 1871, Mill wrote:

> until some mode is pointed out of raising a large revenue by direct taxation to which that [moral] objection does not apply I must think that our indirect taxes had better remain, being only lightened from time to time as the prosperity of the country increases their productiveness.
> (Robson 1963–91, vol. 17: 1859)

An income tax, a house tax, and taxes on luxuries could be regarded as constituting the system of the expenditure tax, which was consistent with the principle of equal sacrifice of enjoyment. Mill considered various devices to prevent these taxes falling on specific people. However, such a consideration applied only to earned incomes. Mill argued that '[i]t is not the fortunes which are *earned*, but those which are *unearned*, that it is for the public good to place under limitation' (Mill 1963–91 [1848], vol. 3: 811; emphasis added). To unearned income, Mill applied a different principle, namely of restoration to the public.

8.4 The restoration programme

8.4.1 Inheritance tax

Mill identified two kinds of unearned income to which the equal-sacrifice principle would not have to apply: income from inheritance; and income from a natural increase in the rent of land.

In the *Principles*, Mill criticized both the French system of equal division and the British laws of primogeniture and entail. Mill's principle of inheritance was that 'all owners of property should . . . have power to dispose by will of every part of it, but not to determine the person who should succeed to it after the death of all who were living when the will was made' (Mill 1963–91 [1848], vol. 3: 895). However, Mill acknowledged that '[u]nder what restrictions it should be allowable to bequeath property to one person for life, with remainder to another person already in existence, is a question belonging to general legislation, not to political economy' (Mill 1963–91 [1848], vol. 3: 895). Thus, Mill concluded:

> As an intermediate course ... I would recommend the extension to all property, of the present English law of inheritance affecting personal property (freedom of bequest, and in case of intestacy, equal division): except that no rights should be acknowledged in collaterals, and that the property of those who have neither descendants nor ascendants, and make no will, should escheat to the state.
>
> (Mill 1963–91 [1848], vol. 3: 888)[31]

To accompany this law of inheritance, Mill proposed a progressive tax to be imposed on any kind of inherited property exceeding a certain amount. Such a tax was permitted because inheritance could be regarded as unearned income. Mill argued:

> I conceive that inheritances and legacies, exceeding a certain amount, are highly proper subjects for taxation: and that the revenue from them should be as great as it can be made without giving rise to evasions. ... The principle of graduation ... that is, of levying a larger percentage on a larger sum, though its application to general taxation would be a violation of first principles, is quite unobjectionable as applied to legacy and inheritance duties.
>
> (Mill 1963–91 [1848], vol. 3: 811–12)

Mill acknowledged that an inheritance tax could fall on capital. However, Mill answered this problem by indicating that: (1) Smith's claim that every tax had to be paid from income, not from capital, was not true; (2) since the tax revenue would be used – at least partly – in order to redeem public debt, an inheritance tax would only transfer the capital from taxpayers to creditors; and (3) the reduction of capital accumulation because of an inheritance tax would be negligible in Britain, where capital was so redundant that it was exported (Mill 1963–91 [1848], vol. 3: 822–4).

In his 1852 evidence, Mill argued that 'I think it is just to make a distinction between property acquired by exertion and that which is inherited, and I would make that distinction very broadly by imposing a [progressive] tax on inheritance and bequest' (Mill 1963–91 [1852], vol. 5: 491). Moreover, Mill elucidated the relationship between income tax and an inheritance tax:

> it would be just to exempt from taxation that portion of income which a man saves; and if he saved it, and invested it, and derived an income from it, I would tax that income, except again such portion as he

> saved. And I would apply that same principle to inherited capital; that is, having taxed it on the inheritance when it came into the possession of the inheritor, I would afterwards tax only such part of the income as the possessor did not save.
>
> (Mill 1963–91 [1852], vol. 5: 494)

Thus, although people would have to pay a progressive inheritance tax when they received a fortune from their parents, they could enjoy exemption from income tax when they increased it for themselves. This measure did not penalize people, because government protected the security of the inheritance, which came into the heirs' possession without their own efforts. The government reserved a right to take a part of such unearned income and use it for the public interest. At the 1861 committee, Mill repeated:

> I do not think that the principle of equality of taxation has any application to the case of taxes on succession. . . . If a person is allowed by the State to succeed to that which he has not earned, but has obtained without any exertion, that is a privilege which he owes to the existence of law and society, to which the State is entitled to annex conditions, and if those conditions are just, when tried by a higher principle of morality, no general principle of equality of taxation has any application to them.
>
> (Mill 1963–91 [1861], vol. 5: 566)[32]

Mill's scheme of a progressive inheritance tax did not belong to the equal-sacrifice programme. The principle Mill adopted for an inheritance tax was that unearned income should be partly restored to the public. Although Mill did not state this as a direct object, the progressive inheritance tax would promote the diffusion of property, and consequently equalize the initial condition of individuals (see Ekelund and Walker 1996: 575).

8.4.2 Land tax

8.4.2.1 James Mill's scheme

Another subject which Mill thought suitable for the restoration programme was the natural increase in the rent – or the value – of land. However, this idea was not originally his: he took it over from his father, James Mill.

On the basis of the Ricardian theory of differential rent and the ideology of philosophic radicalism, James Mill claimed that the rent of land should be the sole, or at least the main, subject for taxation in any country. In his *History of British India* (1817), he argued that '[t]he Hindu mode of raising the revenue of the state, wholly, or most wholly, by taking as much as necessary of the rent of the land . . . has no inconsiderable recommendation from science itself' (Winch 1966: 422), and that '[t]he objections to the Hindu system of providing for the expenses of government, arise from the mode, than the essence' (Winch 1966: 423). The problem which James Mill found with the present mode of revenue in India was that a permanent settlement over *ryots* (cultivators) was given to the *zemindar* (tax-farmer) with respect to his district, and that the *zemindar* paid only the fixed amount of revenue to the government. Consequently, the permanent settlement was considered to be permanent property in the land: the lands were sold and bought; the *zemindars* and the purchasers became extravagant – and often absent – landlords; the *ryots* were deprived of their right in the land, and consequently lost an incentive for capital accumulation and improvements.

Before the Select Committee on the Affairs of the East India Company held in 1831–2, James Mill proposed a land-tenure reform in India. He argued that 'wherever any zemindary property shall come to be sold, it shall be purchased on account of government, and re-settled with the *ryots* upon their old hereditary principle' (Winch 1966: 426). If all lands were nationalized and let to the *ryots*, the revenue system would embody James Mill's ideal – that 'assessment should be made and should be collected from [*ryots*] by the officers of government, without the intervention of a middle-man' (Winch 1966: 424). Thus, the solution which James Mill indicated to the Indian revenue system was a gradual nationalization of land.[33]

In his *Elements of Political Economy*, James Mill maintained that there was 'a peculiar advantage in reserving the rent of land as a fund for supplying the exigencies of the state' (Mill 1821: 199). Although James Mill did not want to interfere with the private ownership of land in Britain, he claimed that it had to be accompanied with a rent-charge by the government on the landholder. However, a number of properties in Britain had been converted into private property – and subsequently sold and bought – without a formal rent-charge. If the government imposed a special tax on the present rent, it would violate the tax-free contract, and consequently disturb people's expectations of security of property. Such a special tax was 'a measure . . . never to be thought of by any government which would regulate its proceedings by the principles of justice' (Mill 1821: 201).

However, Ricardo's theory of differential rent stated that the rent of land would continue to increase as population and the demand for food grew. James Mill did not think that the ownership of such a natural increase in rent should be guaranteed:

> This continual increase arising from the circumstances of the community, and from nothing in which the landholders themselves have any peculiar share, does seem a fund no less peculiarly fitted for appropri-

> ation to the purposes of the state, than the whole of the rent in a country where land had never been appropriated.
>
> (Mill 1821: 253)

Thus, James Mill proposed to impose a special tax on any future increase in the rent of land.[34]

8.4.2.2 John Stuart Mill's scheme

Following his father, John Stuart Mill argued that the land tax was 'a rent-charge in favour of the State, which is to that extent a co-proprietor in the soil' (Mill 1963–91 [1832], vol. 23: 539), and that landlords had no ground for complaining about having to pay the income tax levied on their rent as well as the land tax.[35] Mill espoused this viewpoint more clearly in his evidence before the 1851–2 committee:

> As far as I am acquainted with the nature of the land tax, it seems to me simply a reserve made by the State of a certain portion of the rent of the land, which never properly belonged to the present owners. They or their predecessors were liable to feudal obligations which, if fairly commuted, would have required from them a payment of a much greater amount than the present land tax.
>
> (Mill 1963–91 [1852], vol. 5: 479)

If the land tax was a rent-charge to be paid to the public, it could be raised as the value or the rent of land increased. However, the land tax in Britain was imposed at the 4 shilling rate, on the basis of the fixed value of land which had been assessed in 1692. Consequently, any increase in the rent of land came into the landlords' possession. Such an increase could be a fit subject for a special tax. In the *Principles*, Mill repeated his father's claim:

> This would not properly be taking anything from anybody; it would merely be applying an accession of wealth, created by circumstances, to the benefit of society, instead of allowing it to become an unearned appendage to the riches of a particular class.
>
> (Mill 1963–91 [1848], vol. 3: 819)

Mill designed a practical form for a tax on the natural increase in rent. Because it would be difficult and complicated in practice to assess a natural increase in individual rent, distinguished from an increase ascribed to the landlord's improvements of the land, Mill resorted to a general measure. Mill's plan was to modify the existing land tax per acre, subject to the average market price of land which would be re-estimated periodically. Consequently, the land tax would increase as the value of land increased. Because the average price of land included the capitalized value of future rent, the land tax would increase as rent would be expected to increase (Mill 1963–91 [1848], vol. 3: 819–21).

Mill included the scheme for a variable land tax in the programme of the Land Tenure Reform Association which he established in 1871. The programme was composed of ten articles: (1) to remove all legal and fiscal impediments to the transfer of land; (2) to abolish the law of primogeniture; (3) to restrict the power of tying up land; (4) to impose a tax on the future unearned increase in the rent of land; (5) to promote cooperative agriculture through the purchase of land by the state, and letting it to cooperative associations; (6) to promote the acquisition of land in a similar manner, to be let to small cultivators; (7) to prohibit public or corporate land to be privatized; (8) to retain all waste land for national uses; (9) to retain the less fertile portions of waste land in a state of wild natural beauty; (10) to obtain for the state the power to take possession of natural objects or artificial constructions, attached to the soil, which are of historical, scientific, or artistic interest (Mill 1963–91 [1871a], vol. 5: 689–95n).

In his speech to the society, Mill insisted that a tax levied on the natural increase in the price of land was not a confiscation of property, and that such a tax would be 'easier than to make a just income-tax, and would not give rise to anything like the same amount of unfairness and fraud' (Mill 1963–91 [1873a], vol. 29: 430). Landlords would be exempted from a part of the tax if they kept a record of their improvements to the land. Moreover, Mill gave an option to landlords who did not want to pay this tax: they could sell their land at the current price before it was introduced. The lands which the state bought could be let, for example, to cooperative associations and small cultivators. Thus, Mill argued:

> No class has so direct an interest in the reform of the land system as the farm labourers; it is on State lands that they may hope to see the experiment tried, fairly and on a sufficient scale, of the management of the farm by and for the hands that till it.
>
> (Mill 1963–91 [1873a], vol. 29: 430)[36]

Although Mill's land tax scheme would increase the quantity of state-owned or state-managed land, he did not aim at nationalization of all land – the main purpose of the working-class Land and Labour League.[37] On this issue, Mill's attitude was equivocal. While indicating, in order to obtain the support of the intelligent part of the working class, that the Association went some way towards nationalization of land, Mill emphasized, to the middle and upper class members, that he did not support such a brutal and impossible goal.[38] Like his father, Mill did not believe that nationalization of land – which might be suitable for the revenue and land systems in India – could be carried out in Britain. A tax on the future increase in rent was proposed for use in the restoration programme of unearned income, not a nationalization programme of land.

8.5 Public debt

Mill followed Smith and Ricardo in believing that government expenditure financed by public debt would reduce national capital to be used for the employment of productive labour. Mill also agreed with Thomas Chalmers that the burden of public debt would be incurred ultimately by the labouring class. However, Mill did not support Chalmers' conclusion that any funds required by government for extraordinary expenditure should be raised by a lump-sum tax – not by public debt. To Mill, such a claim could be verified only if all public debts were bought by domestic productive capital, and if such capital were scarce in the home country. In fact, however, a large part of the public debt in the less wealthy countries was served by foreign capital, while in the wealthy countries public debt was financed mainly by the surplus capital which would have been exported to the colonies and foreign countries.[39] 'In these cases,' said Mill, 'the sum wanted may be obtained by loan without detriment to the labourers, or derangement of the national industry, and even perhaps with advantage to both, in comparison with raising the amount by taxation' (Mill 1963–91 [1848], vol. 2: 78).

Mill was not a dogmatic opponent of public debt. Because Britain was a wealthy country which had surplus capital, the government could afford to consider which would be a less harmful measure to finance extraordinary expenditure, public debt or a lump-sum tax. Moreover, public debt had an advantage in that it would take away redundant capital, raise rates of profit, and consequently delay the time when the economy would reach a stationary state. Thus, Mill concluded that 'the only well-grounded economical objection against taking the necessary funds directly from capital, consists of the inconveniences attending the process of raising a revenue by taxation, to pay the interest of a debt' (Mill 1963–91 [1848], vol. 3: 748).

In contrast to a lump-sum tax, public debt required perpetual – at least long-term – taxes in order to pay the interest. Although the interest payments were a mere transfer from the taxpayers to the public creditors, such a forced transfer would disturb national feelings. Moreover, the perpetual taxes would impose inconvenience and diseconomy on the people, above the payment of the money. Therefore, although public debt could raise revenue more advantageously than a lump-sum tax, it should be gradually redeemed. Mill argued: 'The same amount of sacrifice which would have been worth incurring to avoid contracting the debt, it is worth while to incur, at any subsequent time, for the purpose of extinguishing it' (Mill 1963–91 [1848], vol. 3: 876).

Mill thought it unjust to lighten the burden of public debt by inflationary policies (for example, the issue of paper money) or a compulsory reduction of interest. Mill did not accept the scheme that the rate of interest on the public debt contracted in the period 1797–1820 (the period of convertibility suspension) had to be reduced in proportion to the fall in the price level after this period. The public debt was contracted with the condition that convertibility of bank notes would be resumed six months after the end of the war. The public creditors expected that the real value of their interest would increase soon after the war. In fact, however, the resumption was carried out six years – not six months – after the end of the war. Consequently, the public creditors lost the benefit which might have been received from an earlier fall in the price level. A reduction of the real rate of interest on public debt – through inflationary or compulsory policies – would further deprive the public creditors of their legal benefit. Thus, 'if any compensation was due on the ground of depreciation, it would not be from the fundholders collectively, but to them' (Mill 1963–91 [1848], vol. 3: 568).[40]

Mill also rejected Ricardo's capital levy scheme – to extinguish the public debt by imposing a lump-sum tax on property alone. Because people were equally indebted to government expenditure financed by the public debt, it was unjust to make the property holders alone pay off the debt. However, if a one-time income tax – instead of a capital levy – was imposed in order to redeem the public debt, those who had no property would have to borrow money from property holders in order to pay their share of the tax. The rate of interest on a private loan would be higher than that on public debt: non-propertied men would have to pay more than the tax which they paid for the interest on the public debt. Consequently, the extinction of public debt by a one-time income tax – as well as a capital levy – infringed the equal-sacrifice principle (Mill 1963–91 [1848], vol. 3: 876–8). Thus, rejecting all measures which Hume had called 'death by the doctor', Mill concluded that the public debt had to be reduced justly and gradually by using an annual surplus revenue.

However, Mill thought that in a country growing in wealth, a surplus of revenue should be used in order to abolish objectionable taxes rather than reduce public debt. The sole tax which had better be used for the purpose of the redemption of public debt was an inheritance tax. Mill summarized his conclusion concerning debt management:

> it might be expedient to appropriate the entire produce of particular taxes to this purpose [i.e. the extinction of public debt]. . . . The succession duties would be peculiarly suited to such a purpose, since taxes paid as they are, out of capital, would be better employed in reimbursing capital than in defraying current expenditure. If this separate appropriation were made, any surplus afterwards arising from the increasing produce of the other taxes, and from the saving of interest on the successive portions of debt paid off, might form a ground for a remission of taxation.
>
> (Mill 1963–91 [1848], vol. 3: 879)

According to Mill, if a country had surplus capital, the government could issue a public debt without checking economic growth. The interest on the public debt should not be reduced by inflationary or compulsory policies. The public debt should not be extinguished at once by a lump-sum tax. It should be reduced gradually by an inheritance tax. In contrast to Ricardo, Mill did not see the extinction of public debt as urgent. This could be partly attributed to the historical fact that, in Mill's time, public debt as a proportion of national income rapidly diminished (see Section 1.2.3, page 11). Recognizing this fact, Mill believed that the British economy had grown enough to incur the burden of the existing public debt without great difficulty.[41]

8.6 Conclusion

Rejecting the dogmatic laissez-faire principle that the role of government should be limited to protection against force and fraud, Mill allowed for a wider range of government functions. Moreover, considering that Britain had surplus capital, Mill did not think that government expenditure would always prevent economic growth. However, Mill did not positively propose an increase in government expenditure, and suggested that a part of government expenditure on protection against force and fraud – typically on military services – should be shifted into public services for national welfare.

In order to establish a fair and efficient system of taxation, Mill proposed five kinds of taxes: (1) an income tax with the exemption of subsistence income and savings; (2) a house tax imposed in proportion to surplus spending on dwellings; (3) taxes on luxuries at a moderate rate; (4) a tax imposed progressively on inheritances over a certain amount; (5) a land tax assessed on the basis of the market price of the land. The income tax, the house tax and taxes on luxuries constituted the system of expenditure tax, which Mill considered most suited to the principle of equal sacrifice of enjoyment. However, this principle was applied only to earned incomes. Unearned incomes had to be subject to a different principle – a restoration to the public. The progressive inheritance taxes, and the variable land tax, were proposed on the basis of this principle.

Mill was not a dogmatic opponent of public debt. Mill rejected all acute measures for debt redemption. Moreover, Mill argued that surplus revenue should first be used to abolish bad taxes. The sole measure which Mill positively recommended was a redemption of debt by inheritance taxes.

Neither the equal-sacrifice programme nor the restoration programme directly aimed to redistribute income and diffuse property. In fact, Mill continually repeated that he was not biased against a specific class. However, the exemption rule for the income tax was unfavourable to landlords. The progressive inheritance tax would diffuse property, and consequently equalize the initial condition of individuals. A special tax on the future increase in the rent of land would not only reduce the income of landlords but would also lower the value of the land. It would, furthermore, increase the proportion of state land, which would be let to cooperative associations and small cultivators. Finally, a large part of government revenue thus obtained would be spent in order to increase national welfare. Thus, if Mill's fiscal reform programmes had been executed, the rich classes – in particular the landed class – would have gradually lost their advantageous position, while the condition of the middling and working classes would have been improved.[42] However, this result was consistent with his long-term purpose, namely the journey towards a more equitable society.[43]

Notes

1 Sections 8.3 and 8.4 of this chapter draw on Dome (1999).

2 Mill's theory of taxation has been referred to, for example, in Edgeworth (1897: 64–8 and 564–5), Pigou (1971 [1947]: 57), Kaldor (1955: 11–13 and 79–84), Musgrave (1959: 90–3), Shoup (1960: 255–9), O'Brien (1975: 240–71), Ekelund and Tollison (1976 and 1978), West (1978), Hollander (1985: 858–80), and Ekelund and Walker (1996). Although this chapter is indebted to these works, it will show that Mill's works on tax reform may be understood to involve two distinct programmes; the equal-sacrifice programme and the restoration programme.

3 Mill argued that 'the admitted functions of government embrace a much wider field than can easily be included within the ring-fence of any restrictive definition', and that 'it is hardly possible to find any ground of justification common to them all, except the comprehensive one of general expediency' (Mill 1963–91 [1848], vol. 3: 804).

4 For a more precise analysis of the effect of public debt, see Section 8.5 (pages 193–5).

5 This way of assessment was put forward by J. L. Hubberstry in his *Brief Observations on the Necessity of the Property Tax under certain Modifications* (1820). This pamphlet is reproduced in O'Brien (1999, vol. 4: 107–51).

6 If an income tax was perpetuated, a uniform rate of tax would be applied to the nominal annual income, regardless of its duration. For example, if the tax rate was 10 per cent, the land-rent would pay an income tax of £10 annually for 30 years, and the salaries £50 for 6 years. Thus, both would pay an equal percentage of their capitalized value.

7 James Mill did not accept such a differentiation. He argued that it 'would lessen the incomes of the descendants of the owners of permanent incomes, in order to increase those of the descendants of persons with life incomes' and 'would lessen the motive to make savings, by lessening the value of great accumulations' (Mill 1824: 267–8).

8 The idea of a proportional tax on surplus spending can also be seen in Bentham's statement: 'To an English reader it might naturally enough appear, that all that was meant was, that the weight of taxation should bear in a loose sense as equally, or rather as equitably – that is, as proportionally, as it could conveniently be made to do; – that taxes . . . should be imposed – for example, upon superfluities in preference to the necessaries of life' (Bentham 1962 [1795–6a], vol. 2: 518).

9 For the arguments of Radicals such as Thomas Attwood and James Silk Buckingham, see Shehab (1953: 77–8).

10 Mill credited the long-run theory of tax incidence to Nassau Senior. See Mill (1963–91 [1848], vol. 3: 843–7).

11 In the first edition of his *Principles* (1848), Mill demonstrated that it was possible to exempt from taxation the amounts which were *really* saved: 'One expedient might be, that the Income-Tax Commissioners should allow, as a deduction from income, all *bonâ fide* payments for insurance on life. This, however, would not provide for the case which most of all deserves consideration, that of persons whose lives are not insurable; nor would it include the case of savings made as a provision for age. The latter case might, perhaps, be met by allowing as a deduction from income all payments made in the purchase of deferred annuities; and the former by remitting income-tax on sums actually settled, and on sums paid into the hands of public officer, to be invested in securities, and repaid only to the executor or administrator' (Mill 1963–91 [1848], vol. 3: 815n). However, this part was relegated to a footnote in the third edition (1852), and eliminated in the fifth edition (1862). This indicates that Mill gradually gave up considering ways to capture individual savings.

12 Kaldor (1955: 11) referred to Mill, together with Hobbes, Marshall, Pigou, Fisher, and Einaudi, as one of the earlier advocates of the expenditure tax. Mill credited the idea of an expenditure tax to John Revans's *A Percentage Tax on Domestic Expenditure to Supply the Whole of the Public Revenue* (1847): see Mill (1963–91 [1848], vol. 3: 832–3). Revans's pamphlet is reprinted in O'Brien (1999, vol. 5: 97–140).

13 However, Mill wrote: 'Among the excise and custom duties now or lately existing in this country, some must . . . be altogether condemned' (Mill 1963–91 [1848], vol. 3: 871n). In the fifth edition, this sentence was rewritten to read: 'Of the excise and custom duties lately existing in this country, all which are intrinsically unfit to form part of a good system of taxation, have, since the last reforms of Mr. Gladstone, been got rid of' (Mill 1963–91 [1848], vol. 3: 871).

14 See Seligman (1970 [1914]: 137–55), Shehab (1953: 100–11), and Daunton (2001: 91–108).

15 Let £100 be saved in the first year. In the following year, this would increase to £110. If this was expended, a tax of £11 would be imposed, and £99 would be spent on enjoyments. The discounted present value of spending would then be £90 – the same as that if £100 had been expended in the first year.

16 See De Viti de Marco (1936: 232), Shehab (1953: 133–6), and Musgrave (1959: 161–4).

17 For other revisions, see Mill (1963–91 [1848], vol. 3: 811–12, 830–1, and 867–8). The largest revision in the fourth edition in Book 5 concerned a house tax (Mill 1963–91 [1848], vol. 3: 835).

18 See Seligman (1970 [1914]: 161–6), Shehab (1953: 137–57), and Daunton (2001: 154–61).

19 Mill also accepted Hubbard's proposal that profits of capital paid to the capital owner – namely interest on the capital – should be taxed at a higher rate than profits accruing to the capital user (Mill 1963–91 [1861], vol. 5: 559).

20 Mill did not apply the exemption rule to the following people, because they would not have to save for their future wants: 'the case of a tenant in possession of settled property, the case of future possessor, and the case of widow's jointure' (Mill 1963–91 [1861], vol. 5: 556).

21 Later, in the fifth edition of his *Principles* (1862), Mill wrote 'Mr. Hubbard, the first person who, as a practical legislator, has attempted the rectification of the income tax on principles of unimpeachable justice, and whose well-conceived plan wants little of being as near an approximation to a just assessment as it is

likely that means could be found of carrying into practical effect, proposes a deduction not of a fourth but of a third, in favour of industrial and professional incomes' (Mill 1963–91 [1848], vol. 3: 817n).

22 See, for example, Mill (1963–91 [1848], vol. 3: 814 and 816). With respect to revisions in the third and fifth editions of the *Principles*, Robson (1963–91, vol. 3: lxx) wrote that 'it was expected that Book II should contain most altered passages, but it is surprising that Book V has such a large number of revisions'. Considering that many revisions are seen in the statements on the income tax, we can explain the large number of revisions in Book 5 by the fact that Mill was involved in the Select Committees on Income and Property Tax in 1852 and 1861.

23 Ekelund and Walker (1996: 571–3) demonstrate that the income deduction of £100 which Mill proposed exempted about 95 per cent of the British people from the income tax, concluding that 'the exemption shifted the burden to the wealthy, and increasingly to people with massive hereditary (landed) fortune'. However, the problem remains of whether or not Mill himself knew this, and whether he deliberately targeted the landed class in his income tax policy.

24 In his notes on Mill's *Principles*, J. E. Cairnes indicated that a progressive tax could be imposed on surplus spending (Mill 1963–91 [1848], vol. 3: 1051). However, Mill did not alter the sentences to which Cairnes referred.

25 Mill's letter to T. E. Cliffe Leslie, 1 December 1871.

26 This conclusion needs the assumption of inelastic demand for houses. See Edgeworth (1897: 64–8) and Shoup (1960: 101).

27 Mill argued: '[The ground rent was the most] gigantic example extant of enormous accessions of riches acquired rapidly, and in many cases unexpectedly, by a few families, from the mere accident of their possessing certain tracts of land, without their having themselves aided in the acquisition by the smallest exertion, outlay, or risk' (Mill 1963–91 [1848], vol. 3: 835). With respect to a special tax on the ground rent, Mill followed Smith rather than Ricardo. Ricardo believed that such a special tax violated the security of property. See Section 3.3.2 (pages 50–1), and Section 6.3.2.2 (pages 126–7).

28 For example, see Mill's evidence to the 1851–2 committee (Mill 1963–91 [1852], vol. 5: 489 and 496); his speech in Parliament (Mill 1963–91 [1868], vol. 28: 278); and his letter to W. M. Wood in 1871 (Robson 1963–91, vol. 17: 1830).

29 Mill rejected the opinion that the rate of income tax had to be increased in order to abolish the malt tax: this opinion was often proposed by the landed class after the repeal of the Corn Laws. See Mill (1963–91 [1846], vol. 24: 859) and Robson (1963–91, vol. 17: 1857 and vol. 28: 31).

30 Of luxuries consumed by the rich, Mill argued: 'In what manner the finer articles of manufacture, consumed by the rich, might most advantageously be taxed, I must leave to be decided by those who have the requisite practical knowledge. The difficulty would be, to effect it without an inadmissible degree of interference with production' (Mill 1963–91 [1848], vol. 3: 872).

31 Like other Philosophic Radicals, Mill criticized McCulloch's argument which supported the law and custom of primogeniture (Mill 1963–91 [1848], vol. 3: 889–91). For McCulloch's argument see Section 7.5.4, page 162.

32 Mill was concerned with the reform of the existing system of inheritance tax in Britain until the end of his life. For example, in a letter to Thomas Hughes in December 1866, Mill wrote: 'The worst things the House of Commons is now chargeable with on the subject of taxation, are the non-extension of the Probate Duty to real property, and the levying of the Succession Duty, in case of settled property, on the life interest only: and these points, I think, would come in better, à propos of something else' (Robson 1963–91, vol. 16: 1221). Furthermore, Mill thought that the rate of inheritance tax had to be low to

prevent evasion (Mill 1963–91 [1873b], vol. 5: 702 and Robson 1963–91, vol. 17: 1858).

33 For James Mill's overall view on India, see Winch (1966: 383–95) and Barber (1969).

34 It must be stressed that Ricardo did not agree with Mill's proposal for a special tax on rent (Sraffa 1951–73, vol. 9: 132). Winch (1966: 198–9) attributes Mill's land tax scheme to his 'longstanding antagonism towards the land owning class', arguing that 'John Stuart Mill remained closer to his father than to Ricardo on this issue'. For McCulloch's and Ricardo's criticisms of Mill's scheme, see Section 7.4.1 (pages 149–50).

35 See also the *Principles*, Book 5, Chapter 2, Section 6: 'A land tax, in some cases, is not taxation, but a rent-charge in favour of the public' (Mill 1963–91 [1848], vol. 3: 821–2).

36 See also Mill (1963–91 [1871b], vol. 29: 416–24 and 1963–91 [1873c], vol. 25: 1235–43).

37 For the debate on land nationalization between the Land Tenure Reform Association and the Land and Labour League, see Harrison (1965: 233–43).

38 For example, in 1870 Mill wrote to John Boyd Kinnear, who objected to the purchase of land by the state, as well as to a tax on the increase in the rent of land: 'I quite agree with you that public bodies ought not to hold lands; but I think it quite worth trial how the State could manage landed property (which is a great part of its business in India). And of one thing I feel certain that nothing but a trial on a large scale, & for a considerable period, would convince the working classes that such a system would be unsuccessful or injurious' (Robson 1963–91, vol. 17: 1749). See also Mill's letter to Andrew Reid, the secretary for the Association, dated 5 October 1869 (Robson 1963–91, vol. 17: 1643–4).

39 Mill demonstrated that the general rate of interest could be an index to determine whether public debt had been undertaken by surplus capital or necessary capital in the country. The general rate of interest would increase (remain unchanged) if public debt was paid from necessary (surplus) capital (Mill 1963–91 [1848], vol. 3: 874).

40 Mill held this view until his later years. In a letter to Charles Norton in 1868, he wrote: 'The same reasons of justice and good faith apply still more obviously to the condition, expressly stipulated by the lenders, that the interest on the bonds should not be subject to direct taxation' (Robson 1963–91, vol. 16: 1448).

41 Mill argued: 'The burthen of taxation in our own country is very great, yet as every one knows its limit, and is seldom made to pay more than he expects and calculates on, and as the modes of taxation are not of such a kind as much to impair the motives to industry and economy, the sources of prosperity are little diminished by the pressure of taxation; they may even, as some think, be increased, by the extra exertions made to compensate for the pressure of the taxes' (Mill 1963–91 [1848], vol. 3: 882).

42 Ekelund and Tollison (1976: 217) argue that Mill revealed 'great concern for the effects of taxation on the condition of the poor'. West (1978: 571) opposes this view, demonstrating that, if anything, Mill's overall tax proposals were favourable to 'the existing *middle* class' (emphasis in original).

43 In the late nineteenth and early twentieth centuries, the Liberal governments carried out tax reform programmes which bore some similarity to Mill's. For example, a progressive inheritance tax was proposed by William Harcourt in his 1894 budget. Differentiation in the income tax was adopted by Herbert Asquith in 1907. A special tax on the natural increase in the value of land was imposed by David Lloyd George in 1909. Moreover, a progressive income tax – which Mill did not accept – was also introduced in 1909. For Liberal fiscal policy, see Daunton (2001: 245–5 and 360–74).

9 Summaries and conclusion

At the end of 'the Financial Revolution', Hume predicted that Britain would suffer from growing public debt, indicating no concrete way out of the fiscal crisis. The mission – to establish the political economy of public finance – was left to Hume's successors, who were interested in the growth of liberal and commercial society. This book has examined seven authors who took up the challenge. Let us summarize and compare their opinions on three subjects: (1) management of government expenditure; (2) a fair and efficient system of taxation; and (3) debt management. A general conclusion will follow these summaries.

9.1 Management of government expenditure

Steuart and Malthus had a demand-side view of the macroeconomic effect of government expenditure. They demonstrated that government expenditure would create effectual demand and contribute to economic growth. In contrast, the other five authors – Smith, Bentham, Ricardo, Mill, and McCulloch – maintained a supply-side view. They argued that government expenditure was a simple transfer of private consumption or savings into public consumption, and that it would usually prevent economic growth. However, opinions concerning the range and scale of government expenditure subtly differed between the supply-side authors.

Steuart argued that government expenditure would create a demand for the work of the industrious classes. This opinion resulted from his view that money was not only a means of circulation, but also a means of creating an effectual demand. Steuart's argument was also founded on his assumption of a particular stage of economic development – the stage of inland trade, at which favourable foreign trade had been extinguished and unemployment existed. At this stage, an increase in effectual demand would increase the production of commodities, creating demand for the work of the industrious classes. Thus, a statesman could expand the domestic market by government expenditure.

Smith did not adopt Steuart's view. To Smith, although government expenditure did not have to be minimized, it should be limited to a level where private frugality and effort could cover the loss of national wealth. In his *Wealth of Nations*, Smith referred to public works and public institutions – as well as national defence and administration of justice – as services which government had to provide. Smith carefully examined whether every public service had to be covered by the general revenue or paid for by the particular beneficiaries, and concluded that national defence was the main public service which had no other sources of support than the general revenue. Thus, an increase in the expense of defence would always increase public debt and/or taxes. In contrast, a reduction in the expense of defence would be the most effective way to produce surplus revenue. This conclusion formed the basis of Smith's final answer to the British fiscal problem – voluntary separation of the American colonies.

Facing the post-Napoleonic depression, Malthus opposed a sudden reduction of taxes and public debt. Taking a demand-side view of government expenditure, Malthus argued that a reduction of taxes and public debt would diminish aggregate consumption, and consequently aggravate the depression. Malthus believed that there was an optimal ratio of consumption to production, namely a ratio which maximized the rate of economic growth. There must also be an optimal ratio of government to private expenditure. This conclusion was consistent with his main principle of political economy – the doctrine that all results in political economy depended on proportions.

However, in contrast to Steuart, Malthus did not positively propose increasing public debt and taxes in order to increase government expenditure. It was not realistic for Malthus to propose such a policy when there was already a huge volume of public debt and heavy taxes were in force. Moreover, the policy of employing unproductive labour would disturb the long-term balance between population and food production. Consequently, Malthus maintained moderate opinions: taxes should not be imposed, and public debt should not be issued; but if they existed at all, they should not be reduced suddenly, but gradually eliminated.

Criticizing Malthus's demand-side view, Ricardo argued strongly that government expenditure should be minimized in order to prevent its negative effect on capital accumulation. However, Ricardo did not discuss the issue of government expenditure in detail. In fact, his *Principles* had no chapters on this subject.

Although McCulloch argued that government revenue could be spent on defence and the administration of justice, he did not precisely indicate what amount of government expenditure could be permitted on each item. McCulloch discussed the problems of taxes and public debt independently of the scale of government expenditure.

Bentham and Mill employed utilitarian criteria to examine the issue of government expenditure. They believed it necessary to compare the pleasures and pains produced in the community by government expenditure. Bentham argued that, in order to justify government expenditure, the pleasure realized by it had to be superior to the pain produced by the heaviest taxes that would have to be imposed to finance it. Bentham concluded that security was the main purpose of government expenditure.

Mill admitted a wider range of government expenditure than other authors. He accepted not only national defence and administration of justice, but also several optional functions of government which would increase national welfare. Moreover, Mill stated that government expenditure would not prevent economic growth, because in a wealthy country like Britain, redundant capital was exported to foreign countries. However, Mill did not positively propose an increase in government expenditure. He only argued that a part of government expenditure on military services should be shifted into non-military services.

9.2 A fair and efficient system of taxation

Except for Malthus and Ricardo, all the authors we have examined put forward concrete plans for a fair and efficient system of taxation.

Steuart proposed a general sales tax. This tax would fall on idle consumers – the landlords and the moneyed interest – and draw their hoarded money and real property into the commodities market. Because of the demand-creating effect of government expenditure, the domestic market would expand, and the demand for the work of the industrious classes would increase. If all taxes – including the land tax – were commuted into a general sales tax, the tax burden would fall equally on the landlords and the moneyed interest. Consequently, a general sales tax would not only promote economic development, but also maintain the balance between the landlords and the moneyed interest, and produce constitutional stability. However, Steuart's argument was founded on arbitrary assumptions about tax incidence. Moreover, in contrast to Smith, Steuart did not consider an economic system in which profits of capital, rent of land, and wages of labour were repeatedly produced.

Smith demonstrated that most taxes would reduce the rent of land, except for taxes on luxuries. Because the main consumers of luxuries were landlords, taxes on luxuries would also be paid mainly from rent. Thus, the principal taxpayers of the country were landlords. This implied that the landlords would receive most benefit from public retrenchment. Smith's conclusion on tax incidence stemmed from his assumption that whereas manufacturers could move their capital freely, farmers' capital was inseparable from a fixed acreage of land. Consequently, manufacturers could shift taxes onto the price of their commodities, but farmers could not do so. Because the rent of land played a role as a buffer in the price of raw produce, landlords would have to incur the burden of the taxes imposed on farmers. Although Smith proposed several reforms of the land and house taxes, as well as customs and excise duties, his proposal only made clear that there was little room for the government to raise additional revenue from domestic taxes. This negative result gave Smith a good reason to insist on retrenchment.

To Bentham, a fair and efficient system of taxation included an escheat law, an income tax with compensation, and taxes on luxuries. In fact, Bentham proposed an extension of the existing law of escheat, and a tax on bankers' and stock dealers' profits offset by an exclusive privilege. Bentham always intended that his proposals could promote equality – at least prevent inequality. However, Bentham's main concern in the 1790s was to raise revenue without impeding the security-providing principle.

Malthus did not publish his views on a fair and efficient system of taxation: he only argued that a land tax would be better than tithes. With respect to the incidence of taxes, Malthus followed Smith's conclusion that most taxes would ultimately fall on the rent of land. However, in contrast to Smith, Malthus had to make this conclusion compatible with the theory of differential rent, according to which the landlord of marginal land had no ability to pay. Malthus did not solve this problem.

Smith's and Malthus's conclusion – that most taxes would fall on the rent of land – left the problem of how the landlords who received less in rent than they were liable for in taxes could pay. Ricardo solved this problem by using the differential rent theory and the assumption that, like manufacturers, farmers could move their capital freely. Ricardo concluded that most taxes would fall on profits – not rent. This conclusion enabled him to emphasize the negative effect of taxes on capital accumulation and economic growth. Moreover, Ricardo proved that no tax could simultaneously satisfy all his criteria for taxation – distribution neutrality, price neutrality, and consumption reducibility. To Ricardo taxation was nothing but 'political diseconomy', which had to be minimized as far as possible. Of the seven authors, Ricardo was most antipathetic to taxation. In fact, he did not construct an ideal system of taxation, despite Trower's repeated requests.

McCulloch could be regarded as having answered Trower's request for Ricardo. McCulloch treated public finance on the basis of ample data, as well as Ricardian political economy. However, later, considering that social classes depended on rather than conflicted with each other, McCulloch removed the Ricardian propositions about class conflict from his writings on political economy. This change in one of the main principles of his political economy influenced his opinions concerning tax policy. McCulloch did not accept an income tax, because it was impossible to assess individual incomes. McCulloch also rejected the progressive inheritance tax and variable land tax which James and John Stuart Mill proposed. All these taxes belonged to arbitrary and biased policies. McCulloch dismissed any ideas of using taxation in order to redistribute income or diffuse property. To McCulloch, every policy had to apply indiscriminately to all classes. As an indiscriminate method of taxation, McCulloch proposed moderate indirect taxes on a wide basis.

Mill applied the equal-sacrifice programme to earned income, and the restoration programme to unearned income. An income tax which exempted subsistence income and savings, a house tax, and taxes on luxuries belonged to the equal-sacrifice programme. A progressive inheritance tax and a variable land tax belonged to the restoration programme. These programmes followed Benthamite principles of legislation. Like Bentham, Mill gave priority to security over equality, believing that the legislator could pursue equality only if it was consistent with security. However, Mill accepted a wider field than Bentham within which the state could confiscate individuals' income and property without threatening security. For example, Mill's proposal of a progressive inheritance tax was an extension of Bentham's escheat law. Moreover, whereas Bentham suggested abolishing the land tax and integrating it into a general income tax, Mill – following his father, and based on the Ricardian theory of economic growth – proposed a tax on the natural increase in the rent of land. The equal-sacrifice and the restoration programmes would gradually deprive the rich of their advantageous position. This result was consistent with his long-term economic and social policy of progress towards a more equitable society.

9.3 Debt management

None of the seven authors supported Hume's strategy for a 'natural death of public credit', namely a voluntary default by government. They thought that payment of interest on public debt – as well as redemption of the capital – was a necessary condition of liberal and commercial society. However, their views on the best approach to public debt management varied.

Steuart did not believe that an increase in domestic debts would necessarily produce national bankruptcy. If all taxes were commuted into a general sales tax, and landlords and the moneyed interest merged through a voluntary exchange of land and public debt, an issue of public debt would have the same effect as taxation. The burden would fall on idle consumers alone, and produce no distribution effect between taxpayers and public creditors. Because a general sales tax could increase to the point where all real property possessed by idle consumers would be transformed into money, the value of their real property would create general limits to public credit. Money obtained through public debt would be spent in order to increase effectual demand for the work of the industrious classes, and promote economic growth. Consequently, the relative burden of public debt would fall. Thus, public debt would be successfully managed by a general sales tax.

In contrast to Steuart, Smith did not take an optimistic view of public debt. Smith worried that Britain would follow the same course as Holland: government expenditure and public debt had increased; taxes had increased the price of all necessities; consequently, the principal manufactures in the country had been destroyed. Therefore, public debt had to be reduced. Smith preferred Hume's 'natural death of public credit' to 'a pretended payment' – a rise in the denomination of the coinage coupled with its adulteration. However, by voluntary default, the government would lose political support from the moneyed interest. Public debt had to be reduced in good faith through a sinking fund based on a true budget surplus.

In order to produce surplus revenue, Smith proposed several tax reforms. Moreover, because those tax reforms would not produce a large revenue, Smith considered an introduction of imperial taxes. This policy – if feasible – would be most desirable from the viewpoint of Britain's prestige. However, it was no longer realistic because the American colonies had already revolted. Consequently, retrenchment was the only way of producing surplus revenue. The most effective means of retrenchment would be a reduction of the cost of defence. Thus, Smith concluded that voluntary separation of the American colonies would be the sole realistic – if not the best – solution. It would produce surplus revenue, pay the interest on the public debt, pay off redeemable debts, and consequently prevent taxes from being imposed on the necessities of life.

Bentham's ideas for debt management were contained in his Annuity Notes scheme. It aimed to redeem public debt by issuing paper money and by refunding the notes at a lower rate of interest. Bentham believed that this scheme would not only redeem debt, but also increase popular frugality, constitutional stability, and national wealth. However, the scheme had a fatal disadvantage – namely its inflationary tendency – which would violate the security-providing principle. In fact, the Annuity Notes scheme was an example of the method of debt redemption which Hume criticized as the 'death of public credit by the doctor'. Because of this disadvantage, Bentham abandoned the Annuity Notes scheme, and shifted his attention from public finance to monetary regulation.

As was the case with taxation, Malthus opposed a sudden reduction of public debt. Malthus insisted that it should be reduced only gradually. Malthus believed that public debt created the moneyed interest, and that their propensity to consume was larger than other classes of society. Because the interest on public debt was paid by taxation imposed on other classes of society, the extinction of public debt would have had the same distributive effect as a reduction in taxation. Revenue would be transferred from the moneyed interest to the taxpayers. Such a distributive effect would diminish aggregate consumption and, consequently, aggravate the depression. However, this conclusion ignored the problem of how public debt was to be paid off. In fact, Malthus did not specify the means of redemption and its effect on the economy.

Although, in general, Ricardo held a negative view of taxation, he proposed a capital levy in order to redeem the public debt. Ricardo argued that public debt produced the popular illusion of an asset, monopolistic profits for the Bank of England, unreasonable public prejudice against stockholders, and unjust schemes of interest reduction. Thus, public debt not only impeded the growth of national wealth, but also infringed justice and good faith. In order to eliminate these evils, the existing public debt had to be paid off as rapidly as possible.

Ricardo did not support the sinking fund, because the fund was often used by the government in order to make up the budget deficit and issue new public debt. For this reason, he chose a capital levy. However, as Hume had already pointed out, the capital levy scheme was neither realistic nor equitable. In fact, no Members of Parliament supported Ricardo's proposal. Although Ricardo knew that his proposal would not be accepted by the public, he did not give it up. However, Ricardo proposed a capital levy only as a one-time war tax. It was only better than continuous heavy taxes and national bankruptcy. Thus, Ricardo's advocacy of the capital levy scheme did not contradict his fundamental opinion that no perpetual system of taxation could be positively recommended.

McCulloch's view of debt management changed as time passed. In the early stages of his academic career, he supported a compulsory reduction of interest on the public debt which had been contracted during the Napoleonic Wars. This scheme was justified by the assumption that the public creditors benefited from the general fall in prices. However, after finding that the public creditors had lost – not gained – by the fluctuation of prices since the beginning of the Napoleonic Wars, McCulloch abandoned the scheme. By 1820, he had become a supporter of Ricardo's scheme of a capital levy. However, McCulloch realized this scheme was impracticable and unjust, dismissing it in the first edition of *Treatise on Taxation* (1845). Thus, McCulloch abandoned two schemes which Hume had included in the 'death by the doctor'.

After giving up these two schemes, McCulloch relied on economic growth, by which the real burden of the public debt would diminish. McCulloch favoured a balanced-finance policy, arguing that surplus revenue ought to be used to reduce taxes rather than extinguish the public debt. However, at the end of his life, believing that a reduction of indirect taxes had gone too far, and that the income tax – which should have been reserved for a war – would last indefinitely, McCulloch became a supporter of a surplus-finance policy. Hence, the sinking fund had to be maintained in order to make provision for urgent expenses.

Mill was not a dogmatic opponent of public debt. According to him, a wealthy country which had surplus capital could afford to consider public debt as a less harmful means to finance extraordinary expenditure than a lump-sum tax. Even if the wealthy country had no surplus capital, public debt had an advantage, because it would maintain rates of profit, and delay the time when the economy would reach a stationary state. Mill rejected all measures which might cause 'death by the doctor': inflationary policies, a compulsory reduction of interest, and the capital levy scheme.

Mill argued that the public debt had to be reduced justly and gradually by using an annual surplus of government revenue. Moreover, Mill thought that a surplus revenue should be used to abolish objectionable taxes first rather than reduce public debt. The sole tax which could be reserved for the redemption of public debt was an inheritance tax. This measure would dismiss the criticism that, because an inheritance tax was a tax on capital, it would prevent capital accumulation. Repaid money would be most probably invested in productive capital, and consequently, capital accumulation would not be disturbed.

9.4 Conclusion

The different opinions of our seven authors on public finance are attributable to their general principles of political economy, the context in which they wrote, and various non-economic considerations. A traditional laissez-faire/interventionist criterion may distinguish Smith's account of public finance from Steuart's, and Ricardo's from Malthus's. However, it cannot explain the differences between Smith and Ricardo, Steuart and Malthus, Bentham and Mill, Ricardo and McCulloch, or even Mill and McCulloch.

The differences between Smith and Ricardo with respect to tax incidence can be explained – as Ricardo emphasized – in terms of the differential rent theory. Whereas Ricardo's conclusion – that the main taxpayers were capitalists – depended on the differential rent theory, Smith's conclusion – that the main taxpayers were landlords – did not rely on it. The differential rent theory also separated Mill from Bentham on the issue of land-tax reform.

The difference between Smith and Ricardo is also visible in their attitudes towards policy proposals. Smith gave up the utopian proposal of imperial taxation, and accepted voluntary separation of the American colonies as a realistic policy for preventing an increase in public debt. In contrast, Ricardo never gave up the capital levy scheme, although he acknowledged that it would not be accepted in Parliament. Thus, whereas Ricardo thought it a political economist's duty to propose the best policy in theory, Smith adopted a pragmatic emphasis on a 'best in the circumstances' policy.

Every author's opinion on public finance was affected to some degree by the circumstances in which he found himself. Steuart's general sales tax could be regarded as an attempt to complete the excise system which had supported the growth of state institutions since the middle of the eighteenth century. Smith's support for the voluntary separation of the American colonies was also influenced by a period in which most of government revenue was spent on wars and imperialism. Both men lived through the establishment in Britain of 'the fiscal-military state' (Period I).

That Bentham made raising revenue without disturbing the security-providing principle the first priority, and that neither Malthus nor Ricardo put forward an ideal system of taxation, was due to their writing in a period in which the burden of public debt and taxes had reached its limits (Period II). Popular consent to taxation and trust in government – on which 'the fiscal-military state' was founded – was in decline. It was not realistic to propose a further increase in public debt and taxes. This ensured Malthus's opinions differed from Steuart's, although both had a demand-side view.

McCulloch and Mill belonged to a period in which the relative burden of public debt rapidly diminished because of prolonged peace and continuous economic growth (Period III). The legitimacy of and consent to taxation was re-established, and Britain began to move towards 'the civilian-military state'. Redemption of public debt became less important. In fact, McCulloch and Mill had more moderate opinions on debt redemption than their precursors. Thus, differences in opinion about debt redemption between Bentham and Mill, or Ricardo and McCulloch, can be explained by the different fiscal conditions in Periods II and III.

None of the authors considered public finance as a purely economic problem. They discussed public finance from a wider viewpoint which included jurisprudence, politics, and moral science, and were aware of its influence on the stability of the constitution and the improvement of society. The differences in their opinions should be ascribed to their views on non-economic problems, as well as their general principles of political economy and their times. For example, although the differential rent theory indicated that a tax on rent would disturb capital accumulation less than other taxes, Ricardo did not accept any special tax on the rent of land, because to him the security of property was more important than economic growth. In contrast, using the differential rent theory and the Ricardian propositions of class conflict, Mill arrived at proposals for a special tax on the rent of land.

McCulloch and Mill provide a better example. Although both began from Ricardian political economy, and lived during the same period, they approached public finance from quite different perspectives. Whereas McCulloch emphasized the interdependent relationship between classes – and hence the danger of policies which favoured or attacked a specific class – Mill aimed at a more equitable society, and favoured policies which would diminish the advantageous situation of the rich. Moreover, whereas McCulloch followed his Scottish precursors Hume and Smith in acknowledging that policies often produced unintended results, Mill had the Benthamite belief that social reform could be carried through on the basis of well-designed programmes.

Because the seven authors differed in their views of public finance, and because their differences cannot be attributed to a single factor, it may not make sense to talk of 'the' political economy of public finance. However, they were united in attaching great importance to the issue of public finance, and in discussing it as consistently as possible with their general principles of political economy. These two factors connected all of them, knowingly or unknowingly, in the attempt to meet the need Hume had implied for a political economy of public finance. Their struggles with fiscal problems were integral to the formation and development of political economy in Britain in the second half of the eighteenth century and the first three-quarters of the nineteenth century.

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