

ADAM SMITH ON PUBLIC EXPENDITURE AND TAXATION¹

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Resumo: Este artigo apresenta as idéias de Adam Smith sobre tributação e gasto público, que têm sido muito utilizadas no debate contemporâneo sobre o liberalismo. Por meio de um extenso uso das passagens sobre os “deveres do soberano” e das “máximas de tributação”, conclui-se que a defesa da descentralização e a preocupação com o crescimento dos gastos públicos dão o pano de fundo às idéias de Smith. O artigo destaca também o papel crucial das “máximas” e contrapõe-se à usual interpretação de que a teoria da incidência presente na Riqueza das Nações é contraditória e até mesmo sem rumo, face à contemporização de Smith com as práticas de tributação de seu tempo.

Palavras-chave: Adam Smith, tributação, gasto público.

Abstract: This paper presents Adam Smith’s view on taxation and public expenditure, by means of an almost literal reading of the Wealth of Nations famous passages on the “duties of the sovereign” and on the “maxims of taxation”. Contrarily to the commonest usage of these passages, we will show that their core is the preoccupation with the public expenditure soaring and the defence of decentralisation. Furthermore – and also contrarily to the existing interpretations – we defend the non-existence of any contradiction between Smith’s income and price theory (and the incidence hypothesis), provided due attention is paid to the guiding role of the “maxims”.

Key words: Adam Smith, taxation, public expenditure.

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1 INTRODUCTION

The submission of **The Wealth of Nations'** passages on taxation and public expenditure to the scrutiny of the post-Pigouvian public finance theory has been one of the main by-products of the renewed interest in Adam Smith, provoked by the liberal tide of the 1970s and 80s. Musgrave's (1975) and West's (1990) concern with market failure, Musgrave's (1976) comparisons between modern tax fairness concepts and the Smithian maxims, Buchanan's (1976) attention to the "public badness" of governmental action, are just a few examples of the influence of updated analytical findings on the Smith revival.

In spite of the analytical ingenuity of the public good theory, the extension of present days public finance to the classical political economy is not a simple task. The fact that modern economic concepts hardly match with ideas deeply rooted in the intellectual scenery of the eighteenth century stands as a general drawback. Besides, and particularly in what concerns taxation and public expenditure, the misunderstandings have been fuelled by a strong disjunction, which puts public finance theorists on one side and specialists in the 18th century liberalism on the other side. While the former stick to the rationality of modern economics, the latter attempt to put Smith's ideas in the context of his time.³

Winch's position is illustrative of the effects of such a disjunction. Winch's well-known praise of the "historical method" – included in his criticism of the 18th century liberalism commentators exclusively devoted to the "rational method" – is surely aimed at the practitioners of modern economic theory. In the last chapter of his work on Adam Smith's politics (Winch, 1978), it was Stigler's quest for rationality in Smith's ideas on politics⁴ that was taken as **the** example of an intransigent use of the "rational method". The clear relation between Stigler's arguments and Smith's positions on state and markets notwithstanding, Winch symptomatically skipped more specific remarks on taxation and public expenditure,⁵ thus reinforcing an implicitly established agreement: while

3 A broad variety of themes and authors pay respect to the 18th century frame. Among them, the studies on the Scottish Enlightenment (Macfie, 1967; Campbell & Skinner, 1976; Winch, 1978); the reappraisal of Smith's jurisprudence (Taylor, 1965; Lamb, 1987); or even the recovery of Smith's rhetoric (Brown, 1994).

4 Stigler (1971) gets surprised because Smith, who was so attentive to the role of self-interest in economic affairs, failed to give due attention to its role as a general rule to explain the legislation.

5 Winch's book does include a chapter on public debt.

the public finance theorists drive their efforts to the application of post-Pigouvian categories to Book V, the other economists and philosophers avoid Book V's content.⁶ As far as taxation and public expenditure matters are necessarily embedded in political and philosophical reasoning, it is not difficult to figure out the shortcomings brought about by this division of labour.

This article is targeted to a restricted incursion into the empty space created by the above referred dichotomy. By means of a recollection of frequently used and (to my concern) poorly understood passages from **The Wealth of Nations**, I will attempt an intermediate track between the usual application of welfare economics to Smith and the more ambitious endeavour of establishing a methodological contrast between modern public economics and the economics of Adam Smith.

The structure of the text follows the structure of **The Wealth of Nations'** Book V. Apart from this introduction, a second section discusses the "duties of the sovereign", and a third one attempts to apply some lessons collected in the "taxation maxims". The final remarks venture to introduce some afterthoughts on the role of the taxation and public expenditure passages, considering the framework of Smith's liberalism.

Although the article contains references to conflicting interpretations, it is not meant to provide a systematic account of the diverse comments on the public finance chapters. On the contrary, its purpose is to try a meaningful and independent account, which can be summarised by the following points:

- 1) Smith's ideas on taxation and public expenditure have, as a point of reference, the perspective of an increase in the governmental duties, as well as the preoccupation, also to be encountered in the **Lectures on Jurisprudence**, with the blocking effects of inadequate taxes;
- 2) the possibility of a decentralised provision of the "public works and institutions", besides the general contrast between centralisation and decentralisation (and not between public and private expenditure, or between state and markets), are the central themes within the "duties of the sovereign";

⁶ The few exceptions are Musgrave (1976), who takes into consideration the ethics of **The Theory of Moral Sentiments** in his analysis of equity and, to a lesser extent, Rosenberg (1960), who insists on the importance of political institutions in Smith's works.

- 3) the taxation maxims organise and drive the concrete analysis of the existing taxes and, among the criteria encompassed by the maxims, equality performs a subsidiary role;
- 4) the existing collisions between the incidence theory and the recommended taxes, may almost always be explained by the patterns provided by the maxims.

2 THE “DUTIES OF THE SOVEREIGN”

The general framework for the analysis of taxation and public expenditures in Smith includes two issues. Firstly, the conclusion that the progress of societies implies an increase in government commitments, therefore provoking a growing pressure on public resources. Secondly, the concern with the negative impacts that inadequate taxes might impose on production. Both issues strongly influenced the lengthy passages on the advantages and disadvantages of the several types of taxes, and the exposition of the “duties of the sovereign” itself.

The attention to the negative impacts of taxes is a permanent underlying issue, influential in the comments on the types of public resources in several countries, inserted in the second chapter of Book V of **The Wealth of Nations**. Many fiscal experiences, and especially examples from France, illustrate the idea that wrong fiscal systems impose insurmountable barriers to the growth of wealth. This is but a refinement of a general conception, already exposed in the **Lectures on Jurisprudence**, according to which taxes and monopolies are detrimental to the opulence of nations.

The **Lectures** put “commerce and taxation” at the same level, *i. e.*, fiscal and commercial policies, items belonging to the nucleus of Smith’s liberal platform. As a matter of fact, a still unsophisticated theory of value and prices, characteristic of the **Lectures**, drove Smith to the conclusion that taxes and monopolies exerted a similar impact, by raising the market price of commodities above their natural price. For this reason, the *police*, set of policies favouring opulence, included taxation norms as well as the prescription of combating monopolies. The further development of the value and price theory allowed Smith to improve the comprehension of both monopolies and taxation, which became independent subjects in the **Wealth of Nations**, but it did not attenuate the strong concern with the effects of taxation on production, as we will see.

The other issue – the relations between the progress of societies and the duties of governments – became more apparent in the **Wealth of Nations**. In a certain way, this issue underlies the exposition of government tasks, embodied in the “duties of the sovereign”.

Since modern economists have taken the most suggestive clues for a discussion of public goods in Smith from passages of the “duties of the sovereign”, it is convenient to have them reviewed in some detail. For the sake of clearness, I will anticipate further conclusions. To my concern, when discussing the “duties of the sovereign”, Smith aimed at two points:

- on the one hand, the growth of the public expenditure/wealth ratio, a feature inherent to the development of societies;
- on the other hand, the overloading of the Central Treasury, occasioned by the soaring of public expenditures.

Accordingly, his attention was driven to the harmless types of general taxes (subject of Chapter 2), and to the feasible ways of decentralising expenses and/or to the alternative sources of revenues (subject of Chapter 1).

But let us examine the “duties of the sovereign”. Modern economists have considered the first and the second duties incontestable points within the government agenda. In fact, they comprise the defence against foreign enemies and the establishment of justice, typical cases of public goods. Contrarily, the third duty has aroused a considerable and polemical interest, because it comprises the “public goods and institutions” designed to “facilitate the commerce”, which are located on the boundaries between market and state, therefore requiring a subtle analysis based on market failure.

Instead of insisting on a strict opposition among the duties, I think it is worthwhile emphasising that the first and second duties also partake Smith’s concern with the excessive tax burden. The expenses with defence against foreign aggression should be taken as an eloquent illustration of the growing pressures on the “general revenue”, caused by the soaring costs of modern (specialised) armies and by the impossibility of decentralising its defrayal. By its turn, although it contributes to overload the Treasury, the duty of providing justice allows a partial funding by the direct beneficiaries of the lawsuit, thus alleviating “general revenue”.

As a matter of fact, the existence or non-existence of direct benefits is the central issue in designing adequate modes of funding. This point is clearly expressed in the “Conclusion of the Chapter”, a synthetic

statement closing the exposition of the “duties of the sovereign”. In it, Smith states that the first two duties differ because one of them accrues to the “general benefit of the whole society”,⁷ whereas the other, in addition to its accrual to the general benefit, produces a special direct benefit.⁸ In this perspective, the third duty might be seen as an extreme case in the scale from general to particular benefits: the expenses included in it benefit the whole society, but are “most immediately and directly beneficial” (Smith, 1976a, p. 815) to the direct users of the goods. The existence of immediate and direct benefits is a necessary condition for the much praised exaction of extra-Treasury revenues, as tolls and tariffs.⁹

Provided the necessary condition is fulfilled – the existence of direct as well as general benefits –, it is possible to take the third duty as an additional example of the preoccupation with growing expenses. In discussing the third duty, Smith’s purpose was to balance the conveniences and inconveniences of the social arrangements constructed by many nations to assure the provision of commodities and services, which were increasingly important to commercial societies, urging for their decentralisation whenever possible, *i. e.*, whenever there were direct benefits and the individual contributions were enforceable.

Before considering the alternative funding schemes, let us return to the public good concept and try to relate it to the third duty. According to **The Wealth of Nations**:

“The third and last duty of the sovereign or commonwealth is that of erecting and maintaining 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 expence to any individual or small number of individuals, and which it, therefore, cannot be expected that any

7 “The expence of defending the society, and that of supporting the dignity of the chief magistrate, are both laid out for the general benefit of the whole society. It is reasonable, therefore, that they should be defrayed by the general contribution of the whole society...”. (Smith, 1976a, p. 814)

8 “The persons again most immediately benefited by this expence, are those whom the courts of justice either restore to their rights, or maintain in their rights. The expence of the administration of justice, therefore, may very properly be defrayed by the particular contribution of one or other, or both of those two different sets of persons...”. (Smith, 1976a, p. 815)

9 This point is connected with Smith’s attention to the benefit principle as a fair way of defraying costs. More on benefit versus ability to pay below.

individual or small number of individuals should erect or maintain". (Smith, 1976a, p. 723)

Besides the institutions necessary to the protection against foreign enemies and to the provision of justice (dealt with in the first and second duties), the "institutions and publick works" encompassed by the above defined criteria are "...those for facilitating the commerce of the society, and those for promoting the instruction of the people" (Smith, 1976a, p. 723). The first group includes the works and institutions that facilitate "commerce in general" and "particular branches of commerce", being the works and institutions related to "commerce in general" those usually associated to the modern usage of the public good concept, as bridges, roads, water locks.

In order to assess the suitability of the public good concept to the third duty, it is necessary to consider its composing elements, viz., externalities and indivisibility. Are we allowed to conclude, in a flexible reading, that the fact of the works being considered "advantageous to a great society" imply externality? Additionally, does the impossibility of the profit to "*repay the expence to any individual...*" suggest either positive externalities or indivisibility?

A strict externality interpretation is hardly compatible with the **Wealth of Nations**. Quite ably, Musgrave (1985) considers the existence of externality situations not so indisputable in Smith as in Hume's notorious meadow drainage example. "Advantageous to a great society", rather refers to an unspecified general benefit and not to actions whose consequences spill over other agents, being their individual benefits measurable.

On the other hand, the analysts generally accept that some passages of the third duty resemble the public good reasoning and, as far as the public good concept depends on indivisibility, such an allowance would mean an indirect acceptance of the indivisibility case.¹⁰ However, West (1990) has consistently disputed the indivisibility case, showing that **The Wealth of Nations** considers scarce examples of pure indivisibility. Indeed, soon after presenting the third duty, Smith suggests alternatives for the defrayal of its several components, insisting on the role of tariffs and tolls. The absence of obstacles to have the costs of building and maintenance of roads, channels and schooling – the bulk of the "publick work and institutions" – paid by the direct beneficiaries, confirms the divisibility of these services.

¹⁰ Musgrave (1985) and Buchanan (1976), among others, admit the existence of a public good concept in the **Wealth of Nations**.

Yet, irrespective of complying with West's position on divisibility, a sort of addition to the public goods debate might be added. The goods and services funded by tariffs and tolls continue to be considered **public** works and institutions, that is, services whose provision is not (and should not be) arranged by the market. Smith does not dispute the necessity of governmental provision, in spite of the possibilities of having the works maintained by tolls and tariffs. They are "duties of the sovereign" for reasons of a social and political nature, despite the works that "facilitate the commerce" might also be justified on utility grounds, as we will see later.

The adequate mix of funding alternatives – completely funded by the general revenue, partial or total refunding via tariffs and tolls – is an issue to be submitted to the feasibility criterion and to the existence of direct beneficiaries. At any rate, we must clearly distinguish the funding options from the nature of the duties. The choice of funding alternatives does not define the public or private character of the good, as the following analysis of the tolls and tariffs matter will show.

Several reasons lead Smith to recommend the defrayal of public works to be put upon the shoulders of the direct beneficiaries, and/or under the responsibility of local authorities. I think the arguments in favour of the decentralised funding of public goods make one of the main points of the first chapter, providing an optimistic contrast to the pessimistic conclusions about the increasing trend of the pressures on the Central Treasury. Curiously, this issue has barely impressed the analysts.

Let us begin by the tolls and tariffs. Soon after calling our attention to the increasing weight of the third duty, Smith reassures the reader by the conclusion that:

"It does not seem necessary that the expence of those publick works should be defrayed from that publick revenue... of which the collection and application is in most countries assigned to the executive power. The greater part of such publick works may easily be so managed, as to afford a particular revenue sufficient for defraying their own expence, without bringing any burden upon the general revenue of the society". (Smith, 1976a, p. 724)

The manifest purpose of tolls and tariffs, therefore, is to alleviate the "general revenue of the society".

Besides, Smith envisages further advantages in these non-taxing modes of funding:

- 1) they represent an equitable criterion of funding;¹¹
- 2) they admit the establishment of some progressiveness, through differentiated tariffs (for instance, carriages should pay a higher toll than haulage charts);¹²
- 3) the tolls and tariffs block excessive and unjustified public expenses, because, whenever the burden falls upon the customers, the works “... *must be suited to what the commerce can afford to pay*”. (Smith, 1976a, p. 725)

All these additional benefits reinforce the convenience of having the responsibility for the funding put out of the Treasury realm. Besides, the tariff funding allows the works to be put under the control of businessmen, a factor that connects the quality of the services to the amounts to be gathered, thus stimulating managerial efficiency.

Smith put such a high valuation on funding mechanisms that stimulate efficiency that he advised in favour of moving public works of strictly local interest into the responsibility of local authorities, instead of central authorities, even when the “general revenue” shared the burden. The central government should transfer the management in the name of efficiency, so many were the advantages of decentralised management.

In the funding matter, the main topics are the contrast between “general revenue” and decentralised revenues (tolls, tariffs, and regional or local revenues in general), and the contrast between the centralised and the decentralised administration, be it private or not. The same contrast substantiates the famous considerations on school funding, where the central point still is the possibilities of removing the funding out of the Treasury sphere. If the pupils can afford integral fees, so better, but whenever the fees do not suffice to defray the salaries of the teachers, reassures Smith, “... *it still is not necessary that it should be*

11 Smith’s arguments are complex. This sort of funding is just because the beneficiary obtains a net advantage from the public work: the reduction in the costs of transport exceeds the price of the toll. There is equity because the benefit/cost relation is bigger than one and “*his payment is exactly in proportion to his gain*”. (Smith, 1976a, p. 725)

12 Under certain circumstances a progressive taxation is seen as a desirable redistribution of income instrument. More on equity and distributive justice in the next section.

derived from that general revenue of the society...” (Smith, 1976a, p. 759). The educational institutions could be – as they already were, in England – funded by regional revenues or by private donations from the sovereign and from the wealthy people.

Additionally, Smith praised the performance-enhancing role of the system of private fees, as his famous arguments against fixed rewards to teachers show. It is not necessary to recall all the elements in his well-known defence of public (even if privately paid) education, but it should be noted Smith’s diatribe against fixed rewards shares the same stick applicable to the public works and institutions in general. In other words, they share the same efficiency criterion, generally assessable by the answer to a canonical question: “*Have those publick endowments contributed in general to promote the end of their institution?*” (Smith, 1976a, p. 259).

To conclude: the “duties of the sovereign” passages do not seek to establish rational standards, based on efficiency, for the public expenses. These passages do not even entirely lay on economic reasoning. The works and institutions that “facilitate the commerce” perform an economic role – they stimulate economic progress – but they are not public because of their indivisibility, externality, non-excludability *etc.* The provision of security, justice and education are political obligations of the state, as – to a certain extent – the provision of works that “facilitate the commerce” is. How to ably fund these public works, avoiding to overload a Central Treasury (the “general revenue”) already pressed by responsibilities that cannot be delegated, is Smith’s central concern. Decentralisation and the choice of efficiency-enhancing modes of funding are the answer to this concern.

3 THE PRINCIPLES OF TAXATION

The analysis of taxation and incidence, within the second chapter of Book V, is one of the most important derivatives of the theory of price and incomes disclosed in Book I. In Book V, Smith adds specific hypotheses on price formation to the previously established mechanisms of determination of the three categories of income (rent, wages, and profits), in order to determine the real burden of each kind of tax. The core of the theory of tax incidence are the principles determining wages, profits, and the rent of land. These principles allowed Smith to surpass the rather loose assertion that taxes “raise the market price above the natural price”, still present in the **Lectures**, in a route to a complex

general equilibrium model of adjustments among taxes, prices, and incomes.¹³

With few exceptions, the analysts have left aside a proper judgement of Smith's theory of incidence, and have preferred to emphasise the supposed contradictions existing in its use. In fact, Book V mingles the theory of incidence with political concerns and practical knowledge, composing an apparently imprecise mix of theoretical principles and political common sense, considered as an example of Smith's pragmatism and/or as a proof of his analytical flaws.¹⁴ Indeed, it is not difficult to point out several examples of Smith's acceptance of taxes that are unbearable from the viewpoint of his income and incidence theory. For instance, given the pivotal role of subsistence in wage determination, it is impossible to admit that the burden of taxation may be transferred to the workers' shoulders. The same applies to taxes on wage goods, or to taxes upon the rent of houses, which would be shifted to wages. Since all taxes ultimately fall upon the "original revenues" – wages, profit, and rent –, it is impossible to separate Smith's ideas on incidence from his income and price theory. In other words, how to reconcile Smith's price and income theory, and an approach to incidence entirely dependent on it, with the pervasive common sense that seems to underlie the wise comments and advice spread all along Book V?

One of the solutions for this dilemma is to take into account the political economy as "science of the legislator". The relations between the theoretical principles and the prescriptions are never straightforward in the "science of the legislator". There are many steps between the principles and their practical uses.¹⁵ In this sense, the gap between theory and prescriptions is intentional. The importance of the institutional scenery is quite obvious for Smith. Nobody but him to know that taxation rules are based on habits, traditions, and political interests, that is, that a fiscal system has to be feasible in political terms.

13 In fact, a rather incomplete equilibrium model, since the connection among taxation, prices, and revenues remained inconsistent. More on the incompleteness of Smith's allocation model below.

14 On pragmatism and inconsistency in Smith principles of taxation, see Figueiredo (1993) and Musgrave (1985) and Peacock (1985).

15 On political economy as "science of the legislator", Winch (1991). Irrespective of Brown's position (Brown (1994)), refusing to apply the expression "science of the legislator" to the system of natural liberty, I think the conclusions I gather from Winch might be considered immune to her specific criticism.

But my point goes further. I do not see the gap between the economic theory of Book I and the advice on taxation as a sign either of pragmatism or of analytical contradiction. If by pragmatism we understand the lack of well-defined rules, such a qualification does not apply to Smith's proposals, because Smith considers a consistent set of norms which, combined with the theory of incidence, tightly steer his warnings. These norms are announced by the famous "four maxims", of which the subsequent and detailed description of the various types of taxes were but an application.¹⁶

Prior to the recollection of the maxims, it is convenient to remind the general structure of the chapter on taxation. The second chapter of Book V encompasses all the "*sources of the general or publick revenue of the society*" (Smith, 1976a, p. 817), comprising taxes proper, patrimonial revenues, and revenues from business owned and operated by the state. Smith was caustic relatively to the civic virtues and managerial expertise of public managers.¹⁷ If we add to such an antagonism his scepticism towards the efficiency of big organisations in general (public or private), it will be easy to understand his pessimistic stance on the opportunities of expanding public revenue by means of rent of public land and profits of public capital. Therefore, no other instruments but taxes were available to the defrayal of increasing expenses. As we have already seen, this was a reason for permanent preoccupation.

This is the scenery behind Smith's criticism of public administration, spread all through the second chapter. Such a criticism, generally taken as a defence of the privatist faith – which it partially is – should also be seen as a warning about the impacts of the duties upon general revenue. In the end, pressures on general revenue are due to the governmental inability to control its expenses and gather extra-tax reve-

16 That the analytical and historical content of the second chapter is an extension and application of the maxims becomes quite clear when we pay attention to the sentence located at the very end of the presentation of the maxims: "*The following short review of some of the principal taxes which have taken place in different ages and countries will show that the endeavours of all nations have not in this respect – to act accordingly to the maxims (MC) – been equally successful.*" (Smith, 1976a, p. 827-828)

17 "*But whether such a government as that of England; which, whatever may be its virtues, has never been famous for good economy; which, in time of peace, has generally conducted itself with the slothful and negligent profusion that is perhaps natural to monarchies; and in time of war has constantly acted with all the thoughtless extravagance that democracies are apt to fall into...*" (Smith, 1976a, p. 818). Rosenberg (1960) was one of the first authors to emphasise Smith's worries in relation to public servants, suggesting that this might be one of the main reasons for his privatist zeal.

nues. The maxims on taxation and their illustrations have to be understood in view of the shadow of an increasing tax burden.

The first maxim, which defines equality and inequality in taxation, has upset analysts for more than one reason. First of all, Smith proposes (in the same paragraph) both the benefit principle and the ability to pay principle as adequate criteria of taxation. The benefit principle seems to underlie the statement that the individual responsibility for the public expense is similar to the compromises of “*joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate*” (Smith, 1976a, p. 825), while the principle of ability to pay is present in the proposition that it is up to individuals to pay the tax “... *in proportion to their respective abilities*” (Smith, 1976a, p. 825). Although the principles of benefit and ability to pay are today admitted as different – and perhaps opposed – criteria of fairness, Smith effectively adopted both. In some circumstances, he favoured a slight progressiveness, referred to the level of income or wealth of the tax-payers, while, as a general mood, he seemed to be considerably impressed by the ability to pay principle, as when arguing for tolls and tariffs.

The occasional defence of a very moderate progressiveness – in the rent of houses, in the taxation of non-basic goods – should not be overrated. Smith’s concept of equality is referred to the relative incidence upon the three separate types of income. Equality, to him, implies the avoidance of any tax, which might fall upon one of the three types of income, excluding the others.¹⁸ Additionally, his theory of price and income strictly limits the possibilities of imposing an additional burden on wages and profits, and this is a central part of his theory of incidence. The principle of wage determination by the level of subsistence prevents the wages from being taxed, directly or indirectly (taxes on wage goods); the theory of profits hinders the taxation on profits, since they are admittedly the minimal reward for the effort and risk; by its turn, the profit of specific trades cannot be taxed because it would provoke inequality in profit rates, thus affecting equilibrium in the stock market. Therefore, land-owners only, who cannot shift the tax imposed upon their rent to prices, are the target. Since land-owners have no option but to bear the tax, taxation of their rents do not collide with Smith’s income determination theory.

It must be emphasised that it is this lack of flexibility, determined by the theory of incidence, that puts equality policies in a straitjacket. The sparse arguments favouring a smooth progressiveness

¹⁸ “*Every tax, it must be observed once and for all, which falls finally upon one only of the three sorts of revenue..., is necessarily unequal, in so far as it does not affect the other two.*” (Smith, 1976a, p. 825)

in certain taxes should not allow us to overturn Smith's very secondary concern with equality.¹⁹

It is important to remind that Smith's insistent arguing for the tax on the rent of land does not rest on any concept of distributive justice; on the contrary, this tax discriminates against one type of income, thus harming equality. The support of progressiveness in the tax on house rentals,²⁰ sometimes taken as a sign of his commitment to equality, is equally part of a sinuous reasoning, in which the demonstration of the similarity between the house-rent tax and the taxes on consumption goods (in the sense that they fall upon all the three basic incomes) conceals the conclusion that the rich, contrarily to the poor, would hardly succeed in having the tax burden shifted. That is, as much as taxes on luxury goods, house-rent taxes levied on rich people would not produce any impact on prices. The reasoning is based on an allocation, rather than on an equality, concern.

But the sacrifice of equality to any other principle of taxation is perhaps the decisive proof of the secondary role performed by equality within the set of maxims. Whenever the precise assessment of the due amounts to be taxed implies rigorous inspection, Smith abandons the fairness commitments on the grounds of the vexation tax-payers would be subjected to. Taxes which fall upon restricted categories of tax-payers – being, therefore, unequal – are many times accepted, provided they prove themselves suitable to the other principles. Such is the case of the tax on the rent of land and taxes on luxury goods,²¹ which discriminate against determined classes of tax-payers, but conform to the other – and much more important – principles, described in the other maxims.

The second maxim establishes the principle of certainty and non-arbitrariness.²² This principle strictly dominates equality, or, as Smith puts it:

19 Musgrave (1976) is one of the few analysts attentive to the active role of the Smithean theory of price and income and to how it undermines the practice of policies aimed at redistribution.

20 “A tax upon house-rents ... would in general fall heaviest upon the rich; and in this sort of inequality there would not, perhaps, be any thing very unreasonable”. (Smith, 1976a, p. 842)

21 Taxes on luxury goods harm equality because a greater proportion of the rich people's income is spent in luxury goods. Smith has no objection to the taxation on luxury goods consumed by poor people, as spirits and tobacco, because, being non-necessaries, they do not affect wages. He sees an additional advantage in the inhibition of consumption, caused by price-raising effects of the tax.

22 “The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person”. (Smith, 1976a, p. 825)

“... a very considerable degree of inequality ... is not near so great an evil as a very small degree of uncertainty” (Smith, 1976a, p. 826). Smith’s horizons were the arbitrary exaction practices of his time. In his opinion, the countries where the tax-gathering was commissioned to autonomous agents of the kingdom displayed a large array of fiscal abusing.

The convenience of taxation, including the time and manner of payment, forms the third maxim, which also ranks high in Smith’s set of preferences. Convenience and non-arbitrariness together explain many of the admitted exceptions to the principle of equality and the principle of minimal interference in the natural equilibrium. Smith disliked taxes exacted in inadequate time, and praised taxes collected in the moments tax-payers were solvent, as well as taxes exacted “little by little” and in an imperceptible manner. The excises and taxes on consumption goods in general, paid simultaneously to their acquisition, seemed to him a good example of convenience. Taxes on luxury goods are another example, reinforced, in this case, by the additional benefit of choice, as far as the tax-payer might decide not to pay the tax, by simply resigning to the acquisition of the commodity. Provided that we allow land-owners to pay the tax at the same moment they receive the rent, the land-rent tax may be taken as another example of convenience.

The principles defended by the second and third maxims aim at preventing the tax-payer from facing any other annoyance than “...*the unavoidable one of being obliged to pay the tax*” (Smith, 1976a, p. 834). One of the main features of a good fiscal system is exactly the minimisation of an annoyance that is considerable in itself: to pay the tax. To cause the least possible interference in the individual behaviour and in the allocation equilibrium is another feature. Both features, embodied in the second and third maxims, are also considered by the fourth maxim, which is a very ample one, although it seems at a first sight to be only related to the minimisation of the administrative costs of the fiscal apparatus.²³

In reality, of the four possible ways of transgressing the fourth maxim, the first one, which concerns the salaries of the officers in charge of the fiscal apparatus, strictly relates to administrative costs. According to Smith, the value of the tax would also exceed the benefit accrued to the Treasury when:

²³ “... *to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the publick treasury of the state*”. (Smith, 1976a, p. 825)

- 1) the tax hinders certain branches of business;
- 2) the penalties imposed on tax-evaders lead to the end of the business, or to misbehaviour;
- 3) the fiscal controls are vexatious.

That is to say, the fourth maxim encompasses impacts on allocation and moral effects harmful to the system of natural liberty, besides administrative costs proper.

It is worth stressing that inspection procedures familiar to today's routines – access to accounting registers, systematic assessment of taxable values – meant “... *unnecessary trouble, vexation, and oppression...*” (Smith, 1976a, p. 827) for Smith. Because of such inconveniences, he suggested that taxes, such as those incident upon profits or interests, be left aside and recommended the avoidance of any search for equality supposedly conducive to vexation.

The scope of the fourth maxim is ample. Extended to its limits, the warning not to obstruct certain branches of business would restrict the number of adequate taxes, since any tax affecting totally or partially the price of the taxed good alters the economic equilibrium. However, the fact that Smith's equilibrium analysis was not led to its extreme, since it did not take into consideration the impacts of the price changes on the producers themselves, the range of the fourth maxim remains limited. As a matter of fact, Smith did not go beyond the consequences immediately related to his theory of income determination.²⁴

To conclude: together with the income theory, the four maxims provide a comprehensive framework for a concrete analysis of taxation. The maxims explain great part of the admitted transgressions to the theory of incidence, and provide a hierarchy of principles which determines the criteria for the judgement of taxes. Anyway, besides these principles, and as a kind of reasoning in last resource, Smith used an ultimate historical standard: in his vision, the English system of public finance was a paradigm of non-interventionism in private business, comparatively to other countries. Highly inconvenient taxes, as taxes on wage goods, happened to be tolerated because there were no reasonable alternatives for the levying of the necessary amount of resources and – principally – because the percentages applied to the same taxes were still

²⁴ The taxes on necessities, for example, are criticized because they imply a nominal wage increase, but their impacts on the producers of basic goods are not taken into account. The allocation effects of the taxes on luxury goods – defended for other reasons – are also ignored by Smith.

higher in other countries. **The Wealth of Nations** displays several other arguments for the superiority of the English fiscal system, comparatively to others: better mechanisms for the levying of the land-rent tax, the role of custom taxes, the cautious taxation on profits *etc.*

The conclusion that follows Smith's criticism to the taxes on luxury goods may be taken as his ultimate approval of the English fiscal system. Even though the taxes on luxury goods admittedly collide with the fourth maxim in all of the four possible senses, Smith says, they are a bearable fiscal instrument because:

“The inconveniences ... which are, perhaps, in some degree inseparable from taxes upon consumable commodities, fall as light upon the people of Great Britain as upon those of any other country of which the government is nearly as expensive”. (Smith, 1976a, p. 899)

The final statement is quite clear: *“Our state is not perfect, and might be mended; but it is as good or better than that of most of our neighbours”.* (Smith, 1976a, p. 899)

5 FINAL REMARKS

Going beyond its role as a source in taxation matters, Book V has served as a major point of reference in the ample debates on Smith and economic liberalism. The passages on the “duties of the sovereign”, particularly, have many times been used in the current criticism of the governmental economic initiatives as well as an authoritative argument in favour of private business. The scenario of Book V's first and second chapters – preoccupation with the increasing tax burden, concern about the harmful effects of ill-conceived taxes –, added to the frequent allusions to the inefficiency of public service, might induce an ultra-liberal interpretation of Smith's position.

However, the ultra-liberal use of Smith's chapters on public revenues is hardly immune to criticism. First of all, it is meaningful to ask if there is any need for further endorsement of the Smithean thesis on the primacy of private business, after Book I. The establishment of the system of natural liberty and its corollaries, which include the demonstration of the private character of the modern wealth, is sufficiently accomplished by the first chapters of the *Wealth of Nations* and exhaustively complemented by the arguing against mercantilism in Book IV. The chapters presenting Smith's view on the division of labour, exchange, trade, and profit form a

comprehensive (and sufficient) set of arguments in favour of the free market system. The theoretical integrity of Book I is generally underrated by those who concentrate in the sharper ideological rhetoric of Book V in their endorsement of a liberal view.

Secondly, Smith's eloquent criticism to the efficiency of public management also applies to the privately-owned business. In reality, Smith distrusted the big organisation, governmental or not, because it entailed an absence of direct control by the owners, most harmful to economic efficiency. In a symmetrical way, Book V passages criticising joint-stock companies and regulated companies do not prove the inferiority of private business. They are just secondary remarks, in the context of an attack to commercial privileges.

The recollection of the reasons for having commercial privileges, a topic exhaustively debated in Book IV, put back in Book V, is quite insightful. In Book V's context, Smith was analysing the "publick works and institutions to facilitate particular branches of commerce", in contrast to those related to "commerce in general". Within this context, his attention was driven to the public works developed to the benefit of big trade companies. According to Smith, as far as the colonial trade required a strong governmental support, in the form of garrisons and diplomatic action, it seemed reasonable to have its protection defrayed by means of a specific tax, to be levied from trade companies. This is just a strict use of the benefit principle, but the remark that this kind of funding cannot be extended to commerce in general, because

"The protection of trade in general has always been considered as essential to the defence of the commonwealth, and, upon that account, a necessary part of the duty of the executive power". (Smith, 1976a, p. 733)

Therefore requiring a general tax, is quite suggestive. In referring to a duty "essential to the defence of the commonwealth", this passage shows that the *rationale* for an entailing part of the third duty rests on political considerations.

It is important to stress the subtle position of the "duties of the sovereign" in Smith's exposition. These duties do not represent an exhaustive (and restrictive) list of government obligations, in the sense, for instance, of Petty's famous list of governmental tasks, in the **Treatise on Taxes and Contributions**. The duties are not a rational and theoretical device to assess the optimal conditions for governmental expenditure – as the concept of public good implies – either. The "duties of the sovereign" simply partake Smith's broad conception of government

and state-organised societies, which makes allowance for the individual interest but also considers the general and not precisely measurable benefits provided to the whole society.

Instead of looking for a strict rationality quest, we would rather consider that the “duties of the sovereign” passages partake Smith’s conception of the advantages of life in a state-organised society. Far from being a contractarian, in the Lockian sense, Smith was quite sensible to the benefits brought about by the political society. In other words, he admitted that the government accrues to individual interest, but did not derive from this conclusion a contractarian-individualistic theory of the state. His conception of state-organised societies lays both on the utility and on the authority principle.

All public works and institutions, including those that “facilitate the commerce”, benefit both the nation and the immediately concerned businessmen, but they cannot be defended neither on individual benefit grounds nor on strictly measurable collective gains grounds. Needless to say, if public works produce an indisputable individual benefit, their beneficiaries should at any rate participate in the defrayal of the expenses.

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