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Taxing the Wealth of Nations

Adam Smith's work, commonly abbreviated "the Wealth of Nations," clearly details the means by which a nation may procure for itself the greatest national wealth, and the justification for why his ascribed methods will bring about wealth creation and why other methods won't. His analysis of the nature and accumulation of wealth led to the foundation of economics as an academic discipline, and contains numerous insights and recommendations widely upheld to this day. It was, however, ultimately his intention to explore and advance the argument that nations should let the "invisible hand" of individual self interest guide people to the pursuit of their greatest personal benefit and, in so doing, create the greatest wealth possible for the nation with only limited government action. Although many of his recommendations are misguided, Smith nevertheless makes a wise and still applicable appeal for informed government policies which are efficient and grant the most freedom to their people, and against harmful, misguided policies which unduly tax the wealth of nations.

Adam Smith offers few philosophical justifications for taxation, but clearly asserts that it is a necessity for government to function and should be used for public works projects, or, in Smithian terms, anything which is "beneficial to the whole society." It should be noted that Adam Smith was not a libertarian, and fully supported the right (if not the wisdom) of a government to tax, and even encouraged government support of religious institutions: "institutions for education and religious instruction is… beneficial to the whole society, and may, therefore, be defrayed by the general contribution of the whole society" (Smith, 815). Additionally, his statement "every tax… is to the person who pays it a badge, not of slavery, but of liberty" appears the most direct support a notion of freedom and private property which includes taxation. Smith does set some limits on how far it is reasonable for a government to intrude in private and commercial affairs, arguing that determining a tax levy proportional to the amount of trade a shop conducts would be impossible without "an inquisition as would [be]... unsupportable in a free country" (853). Smith does not, however, question the government's ability to properly assess a just tax value or to enter onto private land for that purpose, as in the case of a land survey or "rating" a house, although he does question the efficacy of doing so (834-835, 843). It is likely that Smith recognized a right to privacy of some sort which precludes government from requiring in depth investigations of financial dealings in moveable capital within a specific physical location, as he allows that government registries of such dealings may be required, though its method of enforcement is unclear (858).

Taxation is not only a necessity to fund the proper role and obligations of a state, but is also highly recommended as a means to organize public works projects and services for the benefit of the nation which are not natural incentivized by the pursuit of individual self-interest. According to Smith, the state has three main expenses which cannot solely be satisfied by the market: provision for national defense, administration of justice, and maintaining dignity of the sovereign. The "sovereign" state is charged with "protecting society from the violence and invasion" of other states, and, as such, must pay for the expenses of a military in times of war and peace (689). The rigors of learning military tactics and training, advent of expensive gunpowder weapons, and the existence of a crafts-based, non-agricultural class require the state to maintain class of warriors and/or to justly compensate craftsman for their lost labor in times of war, as they cannot be expected to support themselves otherwise (694-695, 708). Whether professional or conscripted, armaments and soldiers' salaries must be provided by the state, almost certainly deriving originally from taxation.

Smith also argues that justice, while it may be supported almost entirely by fees charged by the court to parties seeking its judgement or as a portion of the penalty of a guilty party, cannot be allowed to operate "by grattis" or gifts lest the administration of justice suffer through underfunding or become corrupted (718-720). Justice itself is necessary to protect people from the animosity of the poor towards wealth inequality which may give rise to theft or destruction of property (715). The "dignity of the sovereign" at the time of Smith's writing referred to a monarchy, but was extended to the "grandeur" bestowed by great families on the Dutch Republic, and may best be understood today as the grandeur of a nation's government buildings and offices (814, 906). This dignity, above and beyond what was required for the execution of the office, Smith believed to be expected by nature of the ruler being set above those he rules. It is, however, unascertainable if Smith included this brief section as a matter of political discretion and thus would have found it unnecessary under a non-monarchical government.

In contrast to taxation as a means of maintaining a state's existence, Smith also emphasizes the ability of government spending derived from taxes to create a net increase in a nation's wealth. He outlines a number of areas for which this may be the case, e.g. the creation of infrastructure, protection of trade, and provision for education. His argument in each specific case is generally guided by the principle that a programs funded from taxation or tools which enhance national wealth are laudable and beneficial:

> "Publick works, which, though they may be in the highest degree of 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... [to] erect and maintain it." (723)

The Wealth of Nations is, ultimately, recommending ways in which the wealth of a nation may be increased, and it is in this sense that Smith encourages government action which facilitates commerce. The circumstances, however, only hold so long as government intervention does not create destructive incentives or take more money out of an economy than it generates. The calculation of societal cost and benefit is fundamentally a positive question and one which Smith devotes considerable time to, however Smith's concern with incentives also indicates an eye towards the best way to structure public works programs to avoid conflicts of interest.

The application of certain principles in the creation of a system of taxation is approached by Smith as a matter of efficiency, or, in modern terminology, in a way which reduces deadweight loss and maximizes net revenue by minimizing the costs of tax collection. There are three concepts which should always be remembered when considering of tax policy to be derived from Smith's writings: all tax money is money taken from a segment of the economy and out of normal economic circulation, any tax should be in proportion to a person's wealth, and a tax is prudent only so long as it is sound. The first guideline provided by Smith is an acknowledgement that government income does not appear from thin air but must, necessarily, be taken from "the private income of individuals" (825). While Smith does allow that the government may maintain assets from which it derives revenue, he disparages the ability of princes or government to function effectively and profitably in a market system, giving the example of the British East India Company as a government affiliated business which required significant government interference to keep it from bankruptcy (817-819). Other ventures, such as the loaning of assets or the Post Office, may be more successful, but are considered too volatile and insubstantial to make up a great part of a government's needed revenue (820-821). Ultimately, government expenses must be funded from taxation, which, by definition, is money which will not be put toward normal market activity by individuals. This removal of wealth from the economy "may obstruct the industry of the people, and discourage them from… business which" would generate jobs and wealth in an economy, thus taxation will "diminish, or perhaps destroy some of the funds" which would enable people to pay higher taxes (826). Smith thus acknowledges that taxation can reduce both the present employment of factors of products and reduce economic growth for the future. It would, therefore, be wise for a government to refrain from high levels of taxation, as doing so would actually harm its ability to collect revenue in the long run.

Secondly, Smith argues for the importance of ensuring each class of society pays taxes proportionate to their wealth. This is generally interpreted to mean that although one's income or tax burden in monetary terms may increase or decrease based upon one's productivity or fortunes in the market, the proportion of income paid in taxes would remain constant. Throughout *The Wealth of Nations*, the phrase "in proportion to their respective abilities" is consistently used in this sense (825). There is, however, evidence that Smith favors a progressive system of taxation which would see the ratio of people's tax burden increase as their real income increases, though he does not devote time to analyze how such a system or its effects may play out. His comment that, "[i]t is not very unreasonable that the rich should contribute to the publick expence, not only in proportion to their revenue, but something more than in that proportion,"is perhaps not a vehement endorsement of progressive taxation, but does suggest it should be considered.(842). His logic likely stems from his view of the role of taxpayers as analogous to "the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests," and so it would follow then, that if a person has greater interests, that person's contribution should be in a ratio proportionate to "their respective interests" or benefit derived (825). Smith is not recommending progressive taxation here, but is leaving the door open to the possibility. Unfortunately, he explicitly states that he will later concern himself only with unequal tax burdens which purport to fall on the same type of income, and not on inequalities of taxation between the different classes of society. Nevertheless, he clearly put emphasis on maintaining a reasonably proportional tax levy on all segments of society, and not, say, excluding a certain class of people such as the clergy or the nobility, which Smith says only aggravates inequality and rewards those who do not improve their lands (835).

Smith's belief that a tax is good only so long as it is sound may be distilled into two positive and two incentive-based maxims to guide analysis of a tax's soundness: convenience, efficiency, and certainty; and clarity and judiciousness. Smith himself identifies only four maxims, but his fourth maxim regarding the "trouble, vexation, and oppression" of examination by tax gatherers is, as a result of earlier statements on tax collectors, more usefully split into the positive and incentive-based aspects of revenue collection, here respectively dubbed certainty and clarity (825-827). Smith uses these maxims as rules for analyzing any particular policy, where the failure of a given tax policy to meet any maxim determines the entire policy to be imprudent, and thus detrimental to an increase in the wealth of a nation. Smith does not assign a moral value to the imprudence of a policy, but simply recommends an alternative means be found, if possible, which does not unduly burden incomes and wealth generation.

The first three maxims, convenience, efficiency, and certainty are positive evaluations which seek to minimize the burden of tax beyond the actual revenue the state seeks to collect. Convenience is defined by Smith as levying a tax "at the time, or in the manner in which it is most… convenient for the contributor to pay," either when they have the most cash-on-hand (in the case of property) or upon the occasion of final purchase and use (in the case of consumer goods) (826). For a farmer or landowner, this would presumably mean collecting taxes following a harvest, when each would possess the most currency on hand and would not have to spend time or energy budgeting to pay taxes later in the year. It is a well known phenomenon in the United States that consumer spending lags in January and February as a result of accelerated consumer spending often financed on credit for the Holiday season in December and the January-February tax season. The inability of consumers to properly maintain consistent monthly spending despite identifiable future needs is a well established example of positive time preference, and Smith is, therefore, correct in pointing out that the time when taxes are levied can have a significant negative impact on economic activity. For taxes on consumer goods, Smith initially supports the concept of a sales tax, paid as the consumer has “occasion to buy the goods” in a convenient way matching their desires which will only through personal folly lead to any “considerable inconveniency from such a tax” (826). However, Smith goes on to recognize the many regressive and consumption suppressing aspects of sales taxes. Licenses, such as on breweries or hypothetically for the consumption of alcohol, fall more heavily on small producers and consumers than large (853, 877). Poll taxes on servants and taxes on necessities “fall heaviest upon the middling rank” and the poor, where their expenses makes up a greater part of their budget than would for a richer household (857, 870-871). By this observation, Smith acknowledges that wealthier individuals spend proportionally less income on lower quality goods and necessities and more on luxuries, though he does not identify principles of utility and demand elasticity which underlie this result. He proposes that luxury taxes could be reasonable, but later recants citing the costs of implementation, increase in tax evasion, and reduced consumption which would result would do large and unnecessary damage to an economy (896-899).

Efficiency, refers to the reduction of deadweight loss on an economy created by a tax by reducing the costs of tax collection “over and above what it brings into the publick treasury of the state” (826). The more complicated a system of taxation is, the more costly it is to implement, the more wasteful and ill-advised it will be, as the salaries and pre-requisite training of tax collectors may “eat up the greater part of the produce of the tax” (ibid). Taking from physiocratic thinking, Smith views bureaucracy as inherently unproductive, which is not altogether at odds with modern thinking so long as one makes the normative assumption that most people prefer business activity. Taxation will thus, “obstruct the industry of the people” to develop otherwise profitable industries and ventures (ibid). General surveys of land values, for example, seem to require "continual and painful attention of government" as they very quickly become inaccurate (836). He considers taxing a percentage of leases to require significantly less work than land surveys from both the government and property owner, while still achieving the same tax levy in an equitable manner (830-831). The most egregious violation of the efficiency maxim which Smith identifies is the area surrounded Montauban, which needed to levy a tax to pay for the correction of inaccuracies of the survey from which a different tax derived, while relying on local officials to disburse the funds appropriately.

Certainty is to be understood as the antonym of arbitrariness, as the amount of a tax, though it may change person to person or year to year, should be predetermined by explicit, transparent regulations and paid at regular, known points in time so as to avoid confusion and inequality in collection. This is done to avoid "subjecting the people to the frequent and odious examination of the tax-gatherers," which may be considered in modernity to mean any action a firm or individual undertakes to process their taxes (827). Smith does recognizes that effort or energy expended to meet the tax expectations is a type of cost, although not a direct drain on resources as it is considered today. Uncertainty has a significant negative impact on economic activity: unexpected tax levies can depress consumer spending (though Smith did not consider this at the time), throw productive processes awry, and reduce investment. For these reason, the "evil" of even a small amount of uncertainty are considerably greater than that of a large degree of inequality (826). Although he primarily opposes taxes on business profits because under the Smithian model it results in raises prices or lowering rents, he also discusses the results on the interest of monetary capital. He opposes taxing monetary capital primarily because it is too difficult to ascertain the wealth of a person, resulting in loose laws, uncertain, and arbitrary tax burdens as those with the ability to do so will find ways to hide their assets or move them abroad (849). He, thus, correctly identifies the issues which face governments of then and today in taxing stocks and investments, and the dilemma of capital flight.

The two incentive-based maxims proposed by Smith, clarity and judiciousness, refer to the effect laws have on restructuring normal market incentives for government agents and tax-payers, respectively. Clarity can be best understood as reducing opportunities for the corruption of government officials, and is thus complementary to the certainty maxim. The more arbitrary a tax is, the more opportunities there are for tax collectors and assessors to “aggravate the tax upon any obnoxious contributor, or extort… some present or perquisite for himself” (825). If laws are not explicit, government representatives are given the agency to determine tax burden, so both tax collector and payer have incentive to corrupt the tax collector, increasing the cost of tax collection beyond the revenue received by the government. This principle may similarly be applied to regulatory policy and lobbying, which, if left without supervision or strict rules, will lead to a corrupted relationship between policy makers and businesses, as in the case of mercantilists (266-267). Smith considered mercantilist policies largely to be the result of this close relationship between policy makers and traders, self-described experts “who were supposed to understand trade” advanced arguments in “the interests of their own particular branch of business” as opposed to all of society, encouraging the “vulgar prejudices” of the mercantile system (434, 266, 681, 555). The monopolistic, irregular and partial justidicial, consumer exploiting, merchant favoring results (630, 610, 660, 309) are a warning from Smith about corrupt incentives.

Judiciousness is ensuring that a tax does not distort incentives so as not to drive economic activity ‘underground’ away from government eyes. The classic example which is used by Smith is smuggling, where trade restrictions on foreign goods does not stop the consumption of those goods, but rather motivates people to sneak them past customs, illegally enter the country, or otherwise subvert border controls. Smith strongly opposes laws which have that result, for as “an injudicious tax offers a great temptation to smuggling… penalties of smuggling must rise in proportion to the temptation" in order to limit it (826). The money spent evading the tax, enforcing it, and punishing offenders is all gone to waste, as far as Smith is concerned. Smith voices some of his strongest arguments against mercantilism along these lines, but he also recognizes that some methods of funding programs create better incentives than others. Using a bridge as an example, Smith recommends that they be built by the state and maintained by a public officials who collects toll as their salary. Drawing on other maxims as well, this ensures that the people who use the infrastructure the most are charged in proportion to their use, minimizes the bureaucratic costs of implementation, ensures that the official has incentive to maintain the bridge, and that he may be replaced if he attempts to charge too much so as to avoid corruption or unduly encumbering trade (727). This is not to say the expensive infrastructure of today should be operated in the same manner, but that taxes are best created with their use in mind, so as to best align them with the economic incentives of their usefulness.

With the conclusion of his analysis of the principles which govern prudent taxation, Smith very clearly states that "*after all the proper subjects have been exhausted… they must be imposed upon improper ones*" and that this is not unwise, but may be necessary to ensure the beneficial programs of the state, of which there are many, can continue (906). The degree of positive activity a state undertakes should, therefore, be analyzed in balance with the negative impact of improper taxes which must be levied to fund them. The government plays a beneficial role wherever it can benefit society through projects whose societal benefit is great, but which could never be an expected result of normal market incentives; Smith considers any such program a public work. In *The Wealth of Nations*, Smith identifies infrastructure projects, institutions for the facilitation of commerce, and education as the three public works programs undertaken by governments which benefit society. That "the erection and maintenance of publick works which facilitate the commerce of any country, such as good roads bridges, navigable, canals, harbours," etc. generally classified as infrastructure today should be the role of government is simultaneously a policy recommendation and Smith's way of how a government should seek to maximize societal benefit (724). Infrastructure is the simplest most concrete example of this role, as it is the physical means by which the specialization-enabling trade can be conducted. Lowering the cost of transit and enabling markets to trade with one another effectively increases a market's size and enables people to take advantage of the returns to scale of specialization (31-33). However, there are other public works projects in which government effectively takes on the role of a business seeking to maximize the profit of its society, such as in providing subsistence level health and sanitation services or basic utilities such as water.

Public work projects are generally simple to understand as an area where government can act to encourage wealth creation, however Smith goes further in saying governments should also be involved in creating institutions which facilitate commerce. Embassies, frontier forts, and navies are three examples of the myriad of ways governments step in to protect and facilitate commerce outside of their normal national security role (731-732). True to form, Smith recommends that those industries which most benefit from a given government program to facilitate trade should be the ones to bear the brunt of the cost, for example, fur trappers paying a tax to support frontier forts which provide protection and trading sites. An extension of this principle to the modern day would be investment companies and banks paying a fee to support the national bank. It is at great length and vociferousness, however, that Smith decries the granting of "regulated companies," better understood today as guilds or mandatory union membership, or government backed monopolies, and uses them as an insistent reminder of why one should take care to abide by his maxims which limit government's role (735-755). Nevertheless, by including the facilitation of trade as an area in which a government should operate, Smith goes beyond limiting government activity to areas of market failure to wheresoever government action can promote greater efficiency or profits.

Education is the final area where Smith encourages an active role for government, by dint of the lack of correlation between wealth and talent. Smith considers it preferable in all cases that students be able to pay for the cost of their instruction themselves or that a grant with few preconditions be given to them so that they may choose their universities for themselves and maintain some competition in the field of education (759, 763). However, Smith deemed it wise to provide a basic education to poorer students to teach generally useful skills, such as "reading writing and accounting," and to prevent the "corruption and degeneracy of the great body of the people," which could engender crime and otherwise hinder economic activity (784-785, 781). Furthermore, he believed the research and scientific developments which stem from university researchers would seldom be funded by the private sector (781). These programs were, according to Smith, inadequately and improperly managed by the private sector, despite the enormous potential benefits for society as a whole. In expanding the role of government past areas where it can create greater efficiency into social goods such as education and research, Smith advances a notion that governments have cause replace normal market activity where government control is demonstrably more efficient and effectively, but only so long as it remains so. It bears restating that Adam Smith is a firm believer in the natural "invisible hand" of the market to guide self-interest to the most efficient result, and it is only in extremely rare circumstances and to a limited extent that he recommends government supplant the private sector. These occasions are only permitted by Smith where government control is better in positive, never normative terms. Nevertheless, such occasions do exist.

Smith clearly sees a role for government wherever it can provide economically beneficial services more effectively and efficiently or where it can help facilitate economic activity, and his lessons for policy analysis still have use today, despite the plethora of changes in technology and economic development. For example, regarding the profits of stock earlier discussed, which Smith deemed too liable to falsification, too expensive to collect, and too difficult to verify, his proposed solution following his model, is to tax land rents which all businesses must possess and cannot be so easily hidden or moved. Unfortunately, the mobility and less land-intensive businesses of today do not lend themselves to taxation in such a way. Even today, the inherent mobility of financial capital can make it extraordinarily difficult, but not impossible, to pin down and tax while preventing its flight to tax havens. Nevertheless, it is with deepest sincerity that Smith says the banking trade should abide by strict and sound regulations, for otherwise in seeking "some flattering speculation or extraordinary gain" investment companies and banks will embark on "extremely dangerous and frequently fatal" ventures (756). Smith saw a place for taxing profits of stock and for regulating the speculative inclinations of the investment market, but he recognized the limitations his day and so proposed alternative methods. However, current technology, development, and market structure lends investment markets far more easily to tracking and taxation, while worsening the dangers and effects of excessive risk. It is logical that, confronted with the situation today, Smith would support a capital gains tax and government regulation of investment markets.

In regards to the public-private relations of the corporate world, Smith would also give pause to the close contact that exists between regulatory bodies, politicians, and corporations, being himself all too familiar with the effect an self-interested body of self-proclaimed experts in the form of mercantilists. A number businesses naturally have incentive to persuade government representatives of the need for trade barriers, and the so-called "revolving door" between government and business as well as the ostensibly open public hearing process creates many possibilities for corrupt motivations. In such a situation it is unlikely that policies which place the costs of trade-facilitating programs be placed on the businesses which most benefit from them. Perhaps it is this relationship that gives rise to the sometimes seemingly arbitrary or wealth-favoring character of a labyrinthine tax code. Is the complexity of the tax code itself a violation of the certainty or efficiency maxims? This is not to say Smith would absolutely suggest different policies, but the above examples do show ways in which Smith's principles and maxims can be used to ascertain whether a given policy is prudent or not, outside of the contextual confines of the 18th century and Smith's economic model.

Taxation is justified by the government's ability to fulfill needs which cannot be supplied by the market and otherwise intervening to create efficiency and efficacy. While Smith's recommendations and policy analyses were limited by his economic model and by the economic and technological development of his time, his principles are still very much applicable to the modern day. It is abundantly clear that Smith argues the vast majority of the market should be left alone to the natural incentives of the private sphere, however he does still envision a role for government which creates and enhances economic inefficiency, and provides still relevant guidelines for avoiding ill-advised policies which imprudently tax the wealth of nations.

Smith, Adam. "An Inquiry into the Nature and Causes of the Wealth of Nations." 1776. Liberty Fund, ed. Oxford University Press. 1981. Print.