

Chapter I.

On The General Principles Of Taxation.

§ 1. Four fundamental rules of Taxation.

One of the most disputed questions, both in political science and in practical statesmanship at this particular period, relates to the proper limits of the functions and agency of governments.

We shall first consider the economical effects arising from the manner in which governments perform their necessary and acknowledged functions.

We shall then pass to certain governmental interferences of what I have termed the optional kind (i.e., overstepping the boundaries of the universally acknowledged functions) which have heretofore taken place, and in some cases still take place, under the influence of false general theories.

The first of these divisions is of an extremely miscellaneous character: since the necessary functions of government, and those which are so manifestly expedient that they have never or very rarely been objected to, are too various to be brought under any very simple classification. We commence, [under] the first head, with the theory of Taxation.

The qualities desirable, economically speaking, in a system of taxation, have been embodied by Adam Smith in four maxims or principles, which, having been generally concurred in by subsequent writers, may be said to have become classical, and this chapter can not be better commenced than by quoting them:(336)

"1. The subjects of every state ought to contribute to 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. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation.

"2. The tax which each individual is bound to pay ought to be certain, and not arbitrary. 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. 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.

"3. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. Taxes upon such consumable goods as are articles of luxury are all finally paid by the consumer, and generally in a manner that is very convenient to him. He pays them little by little, as he has occasion to buy the goods. As he is at liberty, too, either to buy or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconvenience from such taxes.

"4. Every tax ought to be so contrived as both 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 public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury in the four following ways: First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people." Secondly, it may divert a portion of the labor and capital of the community from a more to a less productive employment. "Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax it may frequently ruin them, and thereby put an end to the benefit which the community might have derived from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. Fourthly, by subjecting the people to the frequent visits and the odious

examination of the tax-gatherers it may expose them to much unnecessary trouble, vexation, and oppression": to which may be added that the restrictive regulations to which trades and manufactures are often subjected, to prevent evasion of a tax, are not only in themselves troublesome and expensive, but often oppose insuperable obstacles to making improvements in the processes.

§ 2. Grounds of the principle of Equality of Taxation.

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 judgment in the popular mind.

For what reason ought equality to be the rule in matters of taxation? For the reason that it ought to be so in all affairs of government. A government ought to make no distinction of persons or classes in the strength of their claims on it. If any one bears less than his fair share of the burden, some other person must suffer more than his share. Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person toward 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. There are persons, however, who regard the taxes paid by each member of the community as an equivalent for value received, in the shape of service to himself; and they prefer to rest the justice of making each contribute in proportion to his means upon the ground that he who has twice as much property to be protected receives, on an accurate calculation, twice as much protection, and ought, on the principles of bargain and sale, to pay twice as much for it. Since, however, the assumption that government exists solely for the protection of property is not one to be deliberately adhered to, some consistent adherents of the *quid pro quo* principle go on to observe that protection being required for persons as well as property, and everybody's person receiving the same amount of protection, a poll-tax of a fixed sum per head is a proper equivalent for this part of the benefits of government, while the remaining part, protection to property, should be paid for in proportion to property. But, in the first place, it is not admissible that the protection of persons and that of property are the sole purposes of government. In the second place, the practice of setting definite values on things essentially indefinite, and making them a ground of practical conclusions, is peculiarly fertile in the false views of social questions. It can not be admitted that to be protected in the ownership of ten times as much property is to be ten times as much protected. If we wanted to estimate the degrees of benefit which different persons derive from the protection of government, we should have to consider who would suffer most if that protection were withdrawn: to which question, if any answer could be made, it must be, that those would suffer most who were weakest in mind or body, either by nature or by position.

§ 3. Should the same percentage be levied on all amounts of Income?

Setting out, then, from the maxim that equal sacrifices ought to be demanded from all, we have next to inquire whether this is in fact done, by making each contribute the same percentage on his pecuniary means. Many persons maintain the negative, saying that a tenth part taken from a small income is a heavier burden than the same fraction deducted from one much larger; and on this is grounded the very popular scheme of what is called a graduated property-tax, viz., an income-tax in which the percentage rises with the amount of the income.

On the best consideration I am able to give to this question, it appears to me that the portion of truth which the doctrine contains arises principally from the difference between a tax which can be saved from luxuries and one which trenches, in ever so small a degree, upon the necessities of life. To take a thousand a year from the possessor of ten thousand would not deprive him of anything really conducive either to the support or to the comfort of existence; and, if such *would* be the effect of taking five pounds from one whose income is fifty, the sacrifice required from the last is not only greater than, but entirely incommensurable with, that imposed upon the first. The mode of adjusting these inequalities of pressure which seems to be the most equitable is that recommended by Bentham, of leaving a certain minimum of income, sufficient to provide the necessities

of life, untaxed. Suppose [\$250] a year to be sufficient to provide the number of persons ordinarily supported from a single income with the requisites of life and health, and with protection against habitual bodily suffering, but not with any indulgence. This then should be made the minimum, and incomes exceeding it should pay taxes not upon their whole amount, but upon the surplus. If the tax be ten per cent, an income of [\$300] should be considered as a net income of [\$50], and charged with [\$5] a year, while an income of [\$5,000] should be charged as one of [\$4,750]. An income not exceeding [\$250] should not be taxed at all, either directly or by taxes on necessities; for, as by supposition this is the smallest income which labor ought to be able to command, the government ought not to be a party to making it smaller.

Both in England and on the Continent a graduated property-tax (*l'impôt progressif*) has been advocated, on the avowed ground that the state should use the instrument of taxation as a means of mitigating the inequalities of wealth. I am as desirous as any one that means should be taken to diminish those inequalities, but not so as to relieve the prodigal at the expense of the prudent. 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 neighbors. It is not the fortunes which are earned, but those which are unearned, that it is for the public good to place under limitation. With respect to the large fortunes acquired by gift or inheritance, the power of bequeathing is one of those privileges of property which are fit subjects for regulation on grounds of general expediency; and I have already suggested,⁽³³⁷⁾ as the most eligible mode of restraining the accumulation of large fortunes in the hands of those who have not earned them by exertion, a limitation of the amount which any one person should be permitted to acquire by gift, bequest, or inheritance. 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, by donation *inter vivos* or concealment of property, such as it would be impossible adequately to check. The principle of graduation (as it is called), that is, of levying a larger percentage on a larger sum, though its application to general taxation would be in my opinion objectionable, seems to me both just and expedient as applied to legacy and inheritance duties.

The objection to a graduated property-tax applies in an aggravated degree to the proposition of an exclusive tax on what is called "realized property," that is, property not forming a part of any capital engaged in business, or rather in business under the superintendence of the owner; as land, the public funds, money lent on mortgage, and shares in stock companies. Except the proposal of applying a sponge to the national debt, no such palpable violation of common honesty has found sufficient support in this country, during the present generation, to be regarded as within the domain of discussion. It has not the palliation of a graduated property-tax, that of laying the burden on those best able to bear it; for "realized property" includes the far larger portion of the provision made for those who are unable to work, and consists, in great part, of extremely small fractions. I can hardly conceive a more shameless pretension than that the major part of the property of the country, that of merchants, manufacturers, farmers, and shopkeepers, should be exempted from its share of taxation; that these classes should only begin to pay their proportion after retiring from business, and if they never retire should be excused from it altogether. But even this does not give an adequate idea of the injustice of the proposition. The burden thus exclusively thrown on the owners of the smaller portion of the wealth of the community would not even be a burden on that *class* of persons in perpetual succession, but would fall exclusively on those who happened to compose it when the tax was laid on. As land and those particular securities would thenceforth yield a smaller net income, relatively to the general interest of capital and to the profits of trade, the balance would rectify itself by a permanent depreciation of those kinds of property. Future buyers would acquire land and securities at a reduction of price, equivalent to the peculiar tax, which tax they would, therefore, escape from paying; while the original possessors would remain burdened with it even after parting with the property, since they would have sold their land or securities at a loss of value equivalent to the fee-simple of the tax. Its imposition would thus be tantamount to the confiscation for public uses of a percentage of their property equal to the percentage laid on their income by the tax.

The above proposition has been extended, by those in the United States who appeal to class prejudice, to a proposal to tax the incomes of those who hold government bonds. It so happened that, for example, the six

dollars income on a one-hundred-dollar bond of the United States was not, in the war period, deemed a sufficient equivalent for the risk of loaning one hundred dollars to the state; and Congress, therefore, agreed to relieve them of taxation. It is the same thing to a lender if he receive six per cent directly from the Government, or if he receive seven per cent, and is obliged to pay back one per cent to the treasury in the form of taxation; but to the Government it is another thing, because if it sell a taxed bond at seven per cent interest, it does not receive back the whole of the one per cent tax, but the one per cent tax less the expense of levying it. In other words the Government, in the latter case, pays six per cent interest plus the cost of levying the tax; and consequently borrowed more cheaply in the form of an untaxed bond, as was the hope when the provision was made. If, then, a tax were now to be put upon the bonds, it would fall exclusively on the present holders of them; for, since it diminishes the net income from the bond, it lowers the selling price of the bond itself, as before explained.(338)

§ 4. Should the same percentage be levied on Perpetual and on Terminable Incomes?

Whether the profits of trade may not rightfully be taxed at a lower rate than incomes derived from interest or rent is part of the more comprehensive question whether life-incomes should be subjected to the same rate of taxation as perpetual incomes; whether salaries, for example, or annuities, or the gains of professions, should pay the same percentage as the income from inheritable property.

The existing tax [in England] treats all kinds of incomes exactly alike,(339) taking its [fivepence] in the pound as well from the person whose income dies with him as from the landholder, stockholder, or mortgagee, who can transmit his fortune undiminished to his descendants. This is a visible injustice; yet it does not arithmetically violate the rule that taxation ought to be in proportion to means. When it is said that a temporary income ought to be taxed less than a permanent one, the reply is irresistible that it is taxed less: for the income which lasts only ten years pays the tax only ten years, while that which lasts forever pays forever. The claim in favor of terminable incomes does not rest on grounds of arithmetic, but of human wants and feelings. It is not because the temporary annuitant has smaller means, but because he has greater necessities, that he ought to be assessed at a lower rate.

In spite of the nominal equality of income, A, an annuitant of £1,000 a year, can not so well afford to pay £100 out of it as B, who derives the same annual sum from heritable property; A having usually a demand on his income which B has not, namely, to provide by saving for children or others; to which, in the case of salaries or professional gains, must generally be added a provision for his own later years; while B may expend his whole income without injury to his old age, and still have it all to bestow on others after his death. If A, in order to meet these exigencies, must lay by £300 of his income, to take £100 from him as income-tax is to take £100 from £700, since it must be retrenched from that part only of his means which he can afford to spend on his own consumption. Were he to throw it ratably on what he spends and on what he saves, abating £70 from his consumption and £30 from his annual saving, then indeed his immediate sacrifice would be proportionally the same as B's; but then his children or his old age would be worse provided for in consequence of the tax. The capital sum which would be accumulated for them would be one tenth less, and on the reduced income afforded by this reduced capital they would be a second time charged with income-tax; while B's heirs would only be charged once.

The principle, therefore, of equality of taxation, interpreted in its only just sense, equality of sacrifice, requires that a person who has no means of providing for old age, or for those in whom he is interested, except by saving from income, should have the tax remitted on all that part of his income which is really and *bona fide* applied to that purpose.

If, indeed, reliance could be placed on the conscience of the contributors, or sufficient security taken for the correctness of their statements by collateral precautions, the proper mode of assessing an income-tax would be to tax only the part of income devoted to expenditure, exempting that which is saved. For when saved and invested (and all savings, speaking generally, are invested) it thenceforth pays income-tax on the interest or

profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempted from income-tax, the contributors are twice taxed on what they save, and only once on what they spend. To tax the sum invested, and afterward tax also the proceeds of the investment, is to tax the same portion of the contributor's means twice over.

No income-tax is really just from which savings are not exempted; and no income-tax ought to be voted without that provision, if the form of the returns and the nature of the evidence required could be so arranged as to prevent the exemption from being taken fraudulent advantage of, by saving with one hand and getting into debt with the other, or by spending in the following year what had been passed tax-free as saving in the year preceding. But, if no plan can be devised for the exemption of actual savings, sufficiently free from liability to fraud, it is necessary, as the next thing in point of justice, to take into account, in assessing the tax, what the different classes of contributors *ought* to save. In fixing the proportion between the two rates, there must inevitably be something arbitrary; perhaps a deduction of one fourth in favor of life-incomes would be as little objectionable as any which could be made.

Of the net profits of persons in business, a part, as before observed, may be considered as interest on capital, and of a perpetual character, and the remaining part as remuneration for the skill and labor of superintendence. The surplus beyond interest depends on the life of the individual, and even on his continuance in business, and is entitled to the full amount of exemption allowed to terminable incomes.

§ 5. The increase of the rent of land from natural causes a fit subject of peculiar Taxation.

Suppose that there is a kind of income which constantly tends to increase, without any exertion or sacrifice on the part of the owners: those owners constituting a class in the community, whom the natural course of things progressively enriches, consistently with complete passiveness on their own part. In such a case it would be no violation of the principles on which private property is grounded, if the state should appropriate this increase of wealth, or part of it, as it arises. 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.

Now, this is actually the case with rent. The ordinary progress of a society which increases in wealth is at all times tending to augment the incomes of landlords; to give them both a greater amount and a greater proportion of the wealth of the community, independently of any trouble or outlay incurred by themselves. They grow richer, as it were, in their sleep, without working, risking, or economizing. What claim have they, on the general principle of social justice, to this accession of riches? In what would they have been wronged if society had, from the beginning, reserved the right of taxing the spontaneous increase of rent, to the highest amount required by financial exigencies? The only admissible mode of proceeding would be by a general measure. The first step should be a valuation of all the land in the country. The present value of all land should be exempt from the tax; but after an interval had elapsed, during which society had increased in population and capital, a rough estimate might be made of the spontaneous increase which had accrued to rent since the valuation was made. Of this the average price of produce would be some criterion: if that had risen, it would be certain that rent had increased, and (as already shown) even in a greater ratio than the rise of price. On this and other data, an approximate estimate might be made how much value had been added to the land of the country by natural causes; and in laying on a general land-tax, which for fear of miscalculation should be considerably within the amount thus indicated, there would be an assurance of not touching any increase of income which might be the result of capital expended or industry exerted by the proprietor.

With reference to such a tax, perhaps a safer criterion than either a rise of rents or a rise of the price of corn, would be a general rise in the price of land. It would be easy to keep the tax within the amount which would reduce the market value of land below the original valuation; and up to that point, whatever the amount of the tax might be, no injustice would be done to the proprietors.

In 1870 Mr. Mill became President of the Land Tenure Association, one of whose objects was: "To claim for the benefit of the State the Interception by Taxation of the Future Unearned Increase of the Rent of Land (so far as the same can be ascertained), or a great part of that increase, which is continually taking place, without any effort or outlay by the proprietors, merely through the growth of population and wealth; reserving to owners the option of relinquishing their property to the state at the market value which it may have acquired at the time when this principle may be adopted by the Legislature." It is urged against this plan that, if the Government take for itself the increase from rent, it should also make compensation for loss arising from declining rents, whenever there happens to be any readjustment of values in land.(340)

§ 6. Taxes falling on Capital not necessarily objectionable.

In addition to the preceding rules, another general rule of taxation is sometimes laid down--namely, that it should fall on income and not on capital.

To provide that taxation shall fall entirely on income, and not at all on capital, is beyond the power of any system of fiscal arrangements. There is no tax which is not partly paid from what would otherwise have been saved; no tax, the amount of which, if remitted, would be wholly employed in increased expenditure, and no part whatever laid by as an addition to capital. All taxes, therefore, are in some sense partly paid out of capital; and in a poor country it is impossible to impose any tax which will not impede the increase of the national wealth. But, in a country where capital abounds and the spirit of accumulation is strong, this effect of taxation is scarcely felt. To take from capital by taxation what emigration would remove, or a commercial crisis destroy, is only to do what either of those causes would have done--namely, to make a clear space for further saving.

I can not, therefore, attach any importance, in a wealthy country, to the objection made against taxes on legacies and inheritances, that they are taxes on capital. It is perfectly true that they are so. As Ricardo observes, if £100 are taken from any one in a tax on houses or on wine, he will probably save it, or a part of it, by living in a cheaper house, consuming less wine, or retrenching from some other of his expenses; but, if the same sum be taken from him because he has received a legacy of £1,000, he considers the legacy as only £900, and feels no more inducement than at any other time (probably feels rather less inducement) to economize in his expenditure. The tax, therefore, is wholly paid out of capital; and there are countries in which this would be a serious objection. But, in the first place, the argument can not apply to any country which has a national debt and devotes any portion of revenue to paying it off, since the produce of the tax, thus applied, still remains capital, and is merely transferred from the tax-payer to the fund-holder. But the objection is never applicable in a country which increases rapidly in wealth.