

NOTES AND COMMENTS

Ricardo on income tax: a note

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Despite the fact that Ricardo experienced Pitt's income tax policies, and that he regarded taxation as the most important issue to which the principles of political economy should be applied, he rarely referred to actual tax reforms. This paper indicates that Ricardo's system of economics cannot bring about any tax that is completely compatible with his main criteria for taxation (distribution neutrality, price neutrality and minimum taxation) as well as certainty, convenience and the security of property. This result may explain why Ricardo did not say which type of taxation system the British government should establish.

Key words Income tax, Ricardo

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1. Introduction

The British income tax system was first introduced by William Pitt in 1799 in order to finance the Napoleonic Wars. After being suspended between 1802 and 1803, it was finally abolished in 1816 after the end of the wars. Income tax was revived by Robert Peel in 1842, and it has basically continued in the same form up to the present day. David Ricardo (1772–1823) wrote *Principles of Political Economy and Taxation* (1817, hereafter referred as the *Principles*) after experiencing the heated debates in Parliament concerning the continuation or abolition of Pitt's income tax. He devoted many chapters to the issue of taxation, regarding it as the most important subject to which the principles of political economy could be applied (Sraffa, 1951–55, vol. 8, pp. 132–3).¹ However, the issue of income tax was rarely referred to in his *Principles* and other writings.² In fact, Ricardo never ventured a positive opinion concerning tax reforms or the type of taxation system which the British government should establish after the Napoleonic Wars.

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¹ Ricardo demonstrated his disappointment concerning the fact that Malthus's *Principles* included no independent chapter concerning taxation. He said that 'I am glad to hear that your book will be so soon in the press, but I regret that the most important part of the conclusions from the principles which you endeavour to elucidate, will not be included in it, I mean taxation. . . . As soon as you have launched your present work, I hope you will immediately prepare to give us your thoughts on a subject in which are all practically interested' (Sraffa, 1951–55, vol. 8, pp. 130–1). For the reason why Malthus did not write an independent chapter on taxation, see Dome (1997).

² Ricardo's references to income tax are seen, for example, in Sraffa (1951–55, vol. 1, pp. 152–3, pp. 160–1, p. 242; vol. 3, p. 138, pp. 240–2; vol. 4, pp. 187–9, pp. 216–17; vol. 5, pp. 20–1, p. 187; vol. 6, p. 275, p. 282; vol. 7, p. 25, p. 27; vol. 8, p. 135, pp. 153–4, p. 190, p. 196; and vol. 9, pp. 246–7).

Ricardo's theory of taxation has been referred to, for example, in Blaug (1958, p. 195), Musgrave (1959, pp. 385–92), Marshall (1961, pp. 833–7), O'Brien (1975, pp. 240–71), Hollander (1979, pp. 288–9 and pp. 381–93), Eagly (1983), de Vivo (1987, pp. 195–6), Tullio (1989) and Dome (1992). However, these authors do not examine Ricardo's opinion concerning income tax in detail. In fact, opinions differ with respect to what types of tax Ricardo in fact accepted.¹ Shoup's comprehensive book, entitled *Ricardo on Taxation*, left Ricardo's indeterminate attitude towards income tax as 'a subject for further study' (Shoup, 1960, p. 224).²

The purpose of this paper is to give an answer from a theoretical point of view to the question of why Ricardo did not venture a clear opinion concerning actual tax policy. For this purpose, I shall examine Ricardo's fragmentary statements with respect to income tax on the basis of the theoretical framework that I developed in order to demonstrate his theory of tax incidence (Dome, 1992). The following section shows that, in Ricardo's framework, no tax can satisfy his main criteria for taxation (distribution neutrality, price neutrality and minimum taxation) as well as certainty, convenience and the security of property. In conclusion, this paper infers that this theoretical dilemma prevented Ricardo from putting forward the type of taxation that the British government should establish. This conclusion lends further support to the view that, to Ricardo, taxation was fundamentally a vice associated with the existence of government.

2. Ricardo's statements on income tax

2.1 Early Ricardo

Ricardo's early statements on income tax³ were written in a pamphlet published in 1811.³ These statements are as follows:

To me, however, it appears convincingly certain, that neither the income tax, the assessed taxes, nor many others, do in the least affect the prices of commodities. Unfortunate indeed would be the situation of the consumer, if he had to pay additional prices for those commodities which were necessary to his comfort, after his means of purchasing them had been by the tax considerably abridged. The income tax, were it fairly imposed, would leave every member of the community in the same relative situation in which it found him. Each man's expences must be diminished to the amount of his tax. (Sraffa, 1951–55, vol. 3, p. 241)

The above quotation states Ricardo's criteria for an ideal tax system. He thought that a tax would be ideal if it could achieve the following: (1) leave the distribution of income unchanged; (2) keep prices unchanged; and (3) be paid from consumption.⁴ The first principle demonstrates Ricardo's concept of 'equality' in taxation; let this principle be called the 'principle of distribution neutrality'. The second principle refers to 'price neutrality'. The third principle shows Ricardo's concern about minimising impediments to capital accumulation through taxation, or in other words the 'principle of minimum taxation' or the 'minimum principle'. The above quotation indicates that Ricardo thought

¹ For example, while Blaug (1958, p. 195) states that Ricardo 'was an adamant opponent of the income tax', O'Brien (1975, p. 246) considered that Ricardo 'was in favour of direct taxation'.

² Shoup (1960, pp. 220–3) gives three possible reasons why Ricardo rarely referred to income tax: (1) Ricardo identified income tax as a direct tax on profits; (2) he was only interested in an abstract analysis of taxation; (3) he fundamentally disliked the method of collecting income tax. Shoup considers, however, that not one of these interpretations gives a decisive answer.

³ The title is *Reply to Mr. Bosanquet's Practical Observation on the Report of the Bullion Committee*.

⁴ Shoup (1960, p. 249) shows that Ricardo's interest lay in the economic consequences of taxes with respect to distribution of income, capital accumulation and the price level.

that income tax exhibited the principles of distribution neutrality and price neutrality more than did indirect taxes. Because income tax was expected to be paid from consumption rather than saving, it would not infringe the minimum principle. Thus, at an early stage, Ricardo simply anticipated that income tax would satisfy the three criteria.

What opinions did Ricardo hold concerning Pitt's income tax? Nine days before the income tax was repealed—in a letter to Trower on 9 March 1816—he referred to the Chancellor's final proposal for retention of the tax. He wrote:

I hope you will bring up a petition with you against the property tax. It is more objectionable I think as a 5 percent than as a 10 percent tax, yet I would willingly submit to it if I thought that it would really end in two years. The machinery of it is too easily worked to allow it to be at the disposal of our extravagant ministers during a period of peace. (Sraffa, 1951–55, vol. 7, p. 27)

This is the only reference to Pitt's income tax by Ricardo. It indicates that Ricardo preferred an income tax of 10% for 2 years to one of 5% over a longer period. Considering the fact that, in the first edition of the *Principles*, Ricardo suggested a capital levy in order to redeem the existing national debt (Sraffa, 1951–55, vol. 1, pp. 247–8), we may say that he considered the retention of the income tax for a finite period as a measure to redeem the national debt.¹ However, he did not consider that income tax would be used solely for such a purpose. To Ricardo, the income tax was only a temporary war tax and not a new permanent tax.

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

After the repeal of Pitt's income tax, Ricardo published the first edition of the *Principles*. He followed Smith's chapter of taxation from the *Wealth of Nations* (Chapter II of Book V) in the order in which several types of taxes were examined. Ricardo accepted Smith's four maxims of taxation (equality, certainty, convenience and economy), keeping the principles of price neutrality, distribution neutrality and minimum taxation as fundamental criteria that an ideal tax had to satisfy. In fact, he devoted most parts of his chapters on taxation to the analysis of tax incidence: How would a tax change the natural-price system? Who would carry the final burden of the tax? How would capital accumulation be influenced by the tax? To Ricardo, Smith's first maxim of taxation (that is, equality) meant distribution neutrality. The principles of price neutrality and minimum taxation were referred to from the viewpoint of Smith's fourth maxim of taxation (that is, economy). A tax that infringes these two principles would prevent an efficient use of resources and retard capital accumulation.

In the first edition of the *Principles*, Ricardo made his negative views towards taxation stronger on the basis of the minimum principle. He emphasised that all taxes violated this principle.

There are no taxes which have not a tendency to impede accumulation, because there are none which may not be considered as checking production, and as causing the same effects as a bad soil or climate, a diminution of skill or industry, a worse distribution of labour, or the loss of some useful machinery. (Sraffa, 1951–55, vol. 1, p. 152)²

¹ Asso and Barucci ([1988] 1994, p. 61) report on an unpublished manuscript where Ricardo considered a one-time capital levy of 25%.

² In the second edition of the *Principles* (1819), Ricardo, following McCulloch's suggestions, rewrote these sentences. He weakened the negative expressions, and consequently, made the sentences inconsistent. The revised sentences are: 'There are no taxes which have not a tendency to lessen the power to accumulate. All taxes must either fall on capital or revenue. . . . if they fall on revenue, they must either lessen accumulation, or force the contributors to save the amount of the tax, by making a corresponding diminution of their former consumption of the necessaries and luxuries of life' (Sraffa, 1951–55, vol. 1, p. 152).

Ricardo thought that taxes should be paid from unproductive consumption, acknowledging that they may reduce saving. This fact led Ricardo to Say's golden maxim that 'the very best of all plans of finance is to spend little, and the best of all taxes is, that which is the least in amount' (p. 235).

Ricardo did not clearly show his personal preference for income tax over other taxes. However, we may guess at it from his system of economics and criteria for taxation. The principle of price neutrality would dismiss indirect taxes levied on particular commodities from the list of ideal taxes, because they distort the natural-price system. Ricardo thought that 'every thing which raises the exchangeable value of commodities of any kind, which are in very general demand, tends to discourage both cultivation and production' (pp. 184–5). Any distortion in the price system would not only discourage production but also cause inefficiency. 'More may be raised from the people, than what finds its way into the coffers of the State, as a part, in consequence of its effect on prices, may possibly be received by those who are benefited by the peculiar mode in which taxes are laid' (pp. 234–5). Taxes that distort the natural-price system will therefore hinder the efficient use of resources.

Taxes on raw produce and necessities would raise the prices of the commodity taxed and of all commodities in which raw produce and necessities entered (p. 159–60 and p. 243). Such taxes would also increase money wages, and consequently reduce the uniform rate of profits in all industries. This happens because raw produce and necessities are consumed by labourers and used for production, and because real wages are fixed at the subsistence level. The increase in money wages may cause further changes in the natural prices. Taxes on raw produce and necessities, therefore, violate the principle of price neutrality.¹ They also infringe distribution neutrality, because they fall exclusively on profits: landlords and stockholders carry the burden of the taxes only as consumers. For this reason, Ricardo thought that taxes on raw produce and necessities had to be accompanied by direct taxes on the rent from land and on the dividends from bonds. By doing so, he said, 'all the objects of an income tax would be obtained' (p. 161). Thus, taxes on raw produce and necessities, together with taxes on rent and dividends, could substitute for an income tax, although such indirect taxes would change natural prices.

A tax on luxuries would not reduce the profit rate; it would simply increase the price of the commodity taxed by the amount of the tax (pp. 243–4). This result was based on the assumption that luxuries were not consumed by labourers and that they were not used in the production of any commodity.² From the viewpoint of the minimum principle, a tax on luxuries is desirable, because it will most probably be paid from unproductive consumption. Ricardo discerned, however, the defect of such a tax: 'there is no certainty as to the amount of the tax' (p. 241), because 'from taxes on expenditure a miser may escape' (p. 167). With respect to certainty—Smith's second maxim of taxation—Ricardo acknowledged the advantage of direct taxes. Therefore, taxes on luxuries could not be a central pillar of Ricardo's taxation system.

In contrast to indirect taxes, direct taxes did not violate the principle of price neutrality. No tax on rent or profits—and conditionally, wages—would change natural prices. The theory of differential rent demonstrates that a tax imposed in proportion to rent would fall on the landlord (p. 173).³ One might think that, subject to the minimum principle,

¹ For the condition where a tax on raw produce increases only the price of raw produce by the amount of the tax, see Dome (1992, pp. 47–8) and Erreygers (1995, pp. 820–1).

² Dome (1992, p. 48).

³ For the incidence of land tax and tithes in the Ricardian system, see Dome (1992, pp. 50–2).

Ricardo accepted a single tax on rent because landlords were in general extravagant people. However, this is not true. On the basis of the principle of distribution neutrality and the security of property, he definitely opposed a special tax on land. With respect to a house tax, which may partly fall on the landowner, he wrote:

[I]t would surely be very unjust, to tax exclusively the revenue of any particular class of a community. The burdens of the State should be borne by all in proportion to their means . . . Rent often belongs to those who, after many years of toil, have realised their gains, and expended their fortunes in the purchase of land or houses; and it certainly would be an infringement of that principle which should ever be held sacred, the security of property, to subject it to unequal taxation. (p. 204)

A tax on wages ultimately falls on profits (p. 215). In order for a tax on wages to leave natural prices unchanged, the capital–labour ratio has to be equal between industries.¹ Ricardo fundamentally assumed this condition, recognising that it did not always hold (p. 240). In analysing the incidence of a tax on wages, it was presumed that wages were fixed at the subsistence level. This presumption was justified subject to Malthus's principle of population: if the tax were paid from wages, the labour population would decrease and, consequently, wages would increase. Thus, following Smith, Ricardo concluded that 'the labouring classes cannot materially contribute to the burdens of the State' (p. 235). This means that the employers—that is, capitalists—finally have to carry the burden of the tax levied on wages.²

A tax imposed on the profits of all industries does not alter prices, and is paid from profits (pp. 205–6). Consequently, with respect to the result that profits finally carry the burden, a tax on profits and a tax on wages, as well as taxes on raw produce and necessities, are equivalent. However, a direct tax on profits had a peculiar fault: it cannot be imposed 'without the inconvenience of having recourse to the obnoxious measure of prying into every man's concerns, and arming commissioners with powers repugnant to the habits and feelings of a free country' (p. 161). Thus, a direct tax on profits would infringe on Smith's third maxim of taxation, that is, convenience. Meanwhile, taxes on raw produce and necessities would distort the price system. A tax on wages would also change prices if the capital–labour ratio differed between industries. Thus, Ricardo's statement that 'taxation can never be so equally applied, as to operate in the same proportion on the value of all commodities, and still to preserve them at the same relative value' (p. 239) holds true with respect to taxes indirectly levied on profits.

Ricardo thought that the taxation system—composed of taxes on the rent of land and the dividends of stock, and taxes on one or more of raw produce, necessities, wages and profits—could substitute for the system of income tax. However, it must be noted that such a system does not strictly satisfy distribution neutrality, because, in his system of economics, income tax cannot be paid by labourers. This will increase their relative share of income compared with the landed and capitalist classes. In fact, Pitt's income tax—when we consider the inability of the labouring class to carry the burden—exempted all incomes below £60 (later £50): this exemption actually made all labour incomes free from the tax.³

Ricardo's system of income tax is not price neutral, because it changes natural prices. Only a combination of direct taxes on rent and profits escapes this flaw; but a tax on

¹ See Dome (1992, pp. 49–50) and Erreygers (1995, pp. 820–1).

² In contrast to Ricardo, however, Smith thought that a tax on wages would fall on consumers and landlords. For a theoretical analysis on Smith's theory of tax incidence, see Dome (1998).

³ For the results of Pitt's income tax, see, for example, Seligman ([1914] 1970, pp. 57–113), Studenski (1961, pp. 43–50), and Sabine (1966, pp. 26–41).

profits is inconvenient. Income tax also violates the minimum principle, because a single tax on rent or taxes on luxuries would impede less capital accumulation. However, a single tax on rent infringes distribution neutrality and the security of property, and taxes on luxuries may not produce the required amount of revenue. Consequently, Ricardo's economics cannot bring about any taxation system that is completely compatible with the principles of distribution neutrality, price neutrality and minimum taxation as well as certainty, convenience and the security of property. This theoretical dilemma prevented Ricardo from proposing an actual tax policy for Britain.

2.3 After the first edition of the *Principles*

Ricardo published two revised editions of the *Principles*, in 1819 and 1821. However, we cannot find any significant alterations in the taxation chapters.¹ After the publication of his second edition, he wrote an article for the *Encyclopædia Britannica* entitled 'Funding system'. In the article, Ricardo proposed a capital levy in order to redeem the existing national debt, to which he had briefly referred in the first edition of the *Principles*. The special tax imposed on property would, of course, infringe distribution neutrality. This problem was solved as follows:

Those who are in professions, as well as those who live from salaries and wages, and who now contribute annually to the taxes, could not make a large ready money payment; and they would, therefore, be benefited at the expence of the capitalist and landholder. We believe that they would be very little, if at all benefited by the system of war-taxes. Fees to professional men, salaries, and wages, are regulated by the prices of commodities, and by the relative situation of those who pay, and of those who receive them. A tax of the nature proposed, if it did not disturb prices, would, however, change the relation between these classes, and a new arrangement of fees, salaries, and wages, would take place, so that the usual level would be restored. (Sraffa, 1951–55, vol. 4, pp. 188–9)

Thus, because labour would move between occupations, a capital levy would produce the same effect on income distribution in the long run as an income tax. The capital levy is the only tax that Ricardo ever positively proposed. However, he proposed the capital levy only as a one-time tax to redeem the existing national debt, because he preferred such a tax to refunding the national debt or reserving the sinking fund.² Thus, Ricardo's advocacy of the capital levy does not contradict his fundamental position that no tax could be recommended as a permanent funding system.

With respect to income tax, Ricardo continued to be hedged in by a dilemma of 'whether you should not tax the profits of trade indirectly, by taxing wages, or necessities; and other incomes directly, as rent, dividends, annuities . . .' (vol. 8, p. 154).³ He did not

¹ One revision is his statement concerning taxes on luxuries. In the first edition, he said that 'a minister is disposed to conclude that the country is arrived at the maximum of taxation, because by increasing the rate, he cannot increase the amount of any one of these taxes. But in this conclusion he will not be always correct, for it is very possible that such a country could bear a very addition to its great burdens without infringing on the integrity of its capital' (Sraffa, 1951–55, vol. 1, p. 242, n. 1). In the second edition, he altered it into the following: 'a minister is induced to have recourse to more direct taxes, such as income and property taxes, neglecting the golden maxim of M. Say, "that the very best of all plans of finance is to spend little, and the best of all taxes is that which is the least in amount"' (p. 242). Ricardo made this alteration because, following McCulloch's suggestion, he thought that the first statement would 'hold out an apology to ministers for taxation' (Sraffa, 1951–55, vol. 7, p. 337).

² Ricardo did not believe that his proposal would be accepted by the public (Sraffa, 1951–55, vol. 8, p. 187). For Ricardo's motive in proposing a capital levy, see, for example, Asso and Barucci ([1988] 1994) and Churchman (1995).

³ Ricardo referred to a tax on profits in a letter to Trower on 28 January 1820, stating that 'profits can never be known without a minute scrutiny into the affairs of those concerned in trade' (Sraffa, 1951–55, vol. 8, p. 154). Thus, he thought that a direct tax on profits would violate certainty as well as convenience.

answer this question, and became more negative with respect to a revival of an income tax. Similarly to McCulloch, Ricardo agreed that ‘an income tax is by no means a desirable tax, situated as we are, instead of the taxes now levied’ (p. 196).¹

Trower was eager to know what type of taxation system Ricardo attempted to establish on the basis of his theory. After the publication of the second edition of the *Principles*, he suggested Ricardo make the theory of taxation more perfect and apply it to the real situation in Britain (Sraffa, 1951–55, vol. 8, p. 70). Ricardo side-stepped this suggestion, answering that ‘the first step must be to make the first principles of Political Economy known’ (p. 79). Trower did not give up. When Ricardo wrote an article on the funding system, Trower asked Ricardo to demonstrate first of all ‘how, in the event of diminished revenue, or of increased expences, can we raise the funds necessary for our *current expenditure?*’ (p. 110). This time, Ricardo answered that ‘on some future day, I will bend my whole mind to the consideration of this subject’ (p. 132). However, this promise was not carried out. Finally, after the publication of the third edition of the *Principles* (1821), Trower requested Ricardo to produce a real taxation system that could be derived from his economic system (Sraffa, 1951–55, vol. 9, p. 69). To this request, Ricardo’s answer was that ‘I, as well as you, would like to see an application of the Principles of Political Economy, as now understood, to the practical operation of taxation, and I hope it will not be long before such a work appears’ (p. 87). However, this answer did not mean that he would produce ‘such a work’. Ricardo concluded that ‘you make a great mistake in supposing me capable of producing so important a work’ (p. 88).

In fact, Ricardo demonstrated no positive idea with respect to a new taxation system to be introduced in the future of Britain. His attitude towards all taxes was simply negative: he opposed the revival of income tax, at the same time as approving a reduction in the existing taxes. In Parliament in 1822, he voted for every proposal for tax reduction, sweeping away the misunderstanding that he was an advocate of taxation (Sraffa, 1951–55, vol. 5, p. 154). Thus, Ricardo gave up any attempt to establish a concrete taxation system derived from his abstract theory of taxation.

3. Conclusion

This paper has demonstrated that Ricardo’s system of economics could not bring about any taxation system that was completely compatible with the principles of distribution neutrality, price neutrality and minimum taxation as well as convenience, certainty and the security of property. This dilemma may explain why Ricardo gave up trying to establish an ideal taxation system, and why he did not often refer to actual tax policy such as an income tax. He knew that an income tax did not fit his criteria for taxation, and that there was no other tax that could satisfy these criteria. Ricardo reached the conclusion that ‘taxation under every form presents but a choice of evils’ (Sraffa, 1951–55, vol. 1, p. 167). The following statement shows his fundamental viewpoint on taxation:

We very soon arrive at the knowledge that Agriculture, Commerce, and Manufactures flourish best when left without interference on the part of Government, but the necessity which the state has for money to defray the expences of its functions, imposes on it the obligation to raise taxes, and thus interference becomes absolutely necessary. (Sraffa, 1951–55, vol. 8, p. 133)

¹ Ricardo’s letter to McCulloch on 13 June 1820.

In contrast to Smith, Ricardo underestimated the role of government in the economy, and overestimated the cost of it. In fact, Ricardo's *Principles* has no chapter on government expenditure—the *raison d'être* of government—like that in Smith's *Wealth of Nations*. What Ricardo achieved in the taxation chapters of the *Principles* was to prove that taxation was equated to a 'national evil' or 'political diseconomy' caused by governments.¹ Taxation was the most important subject in a negative sense where perfect knowledge of political economy is required. If this is true, the title of his book should be changed to the *Principles of Political Economy and Diseconomy*.

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¹ This conclusion supports Fetter's viewpoint that 'Ricardo's belief that self-interest was the wellspring of economic development also went beyond Smith in Ricardo's almost pathological feeling that the government did everything badly' (Fetter, 1969, p. 73), and Hutchison's that Ricardo 'is not merely the *only*, but outstandingly the *most*, thoroughgoing advocate of *laissez-faire* among the major British economists' (Hutchison, 1978, p. 51).