BOOK III

THE LAWS OF DISTRIBUTION

The machines that are first invented to perform any particular movement are always the most complex, and succeeding artists generally discover that with fewer wheels, with fewer principles of motion than had originally been employed, the same effects may be more easily produced. The first philosophical systems, in the same manner, are always the most complex, and a particular connecting chain, or principle, is generally thought necessary to unite every two seemingly disjointed appearances, but it often happens that one great connecting principle is afterward found to be sufficient to bind together all the discordant phenomena that occur in a whole species of things.

—ADAM SMITH,
Essay on the Principles Which Lead and Direct Philosophical Inquiries, as Illustrated by the History of Astronomy.

Chapter 1 The Inquiry Narrowed to the Laws of Distribution—The Necessary Relation of These Laws

The preceding examination has, I think, conclusively shown that the explanation currently given, in the name of political economy, of the problem we are attempting to solve, is no explanation at all.

The preceding examination has shown that neither a lack of capital nor increases in population can explain why wages decrease with the advance of material progress.

That with material progress wages fail to increase, but rather tend to decrease, cannot be explained by the theory that the increase of laborers constantly tends to divide into smaller portions the capital sum from which wages are paid. For, as we have seen, wages do not come from capital, but are the direct produce of labor. Each productive laborer, as he works, creates his wages, and with every additional laborer there is an addition to the true wages fund—an addition to the common stock of wealth, which, generally speaking, is considerably greater than the amount he draws in wages.

Nor, yet, can it be explained by the theory that nature yields less to the increasing drafts which an increasing population make upon her; for the increased efficiency of labor makes the progressive state a state of continually increasing production per capita, and the countries of densest population, other things being equal, are always the countries of greatest wealth.

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So far, we have only increased the perplexities of the problem. We have overthrown a theory which did, in some sort of fashion, explain existing facts; but in doing so have only made existing facts seem more inexplicable. It is as though, while the Ptolemaic theory was yet in its strength, it had been proved simply that the sun and stars do not revolve about the earth. The phenomena of day and night, and of the apparent motion of the celestial bodies, would yet remain unexplained, inevitably to reinstate the old theory unless a better one took its place. Our reasoning has led us to the conclusion that each productive laborer produces his own wages, and that increase in the number of laborers should increase the wages of each; whereas, the apparent facts are that there are many laborers who cannot obtain remunerative employment, and that increase in the number of laborers brings diminution of wages. We have, in short, proved that wages ought to be highest where in reality they are lowest.

We have proved that wages ought to be highest where in reality they are lowest.

Nevertheless, even in doing this we have made some progress. Next to finding what we look for, is to discover where it is useless to look. We have at least narrowed the field of inquiry. For this, at least, is now clear—that the cause which, in spite of the enormous increase of productive power, confines the great body of producers to the least share of the product upon which they will consent to live, is not the limitation of capital, nor yet the limitation of the powers of nature which respond to labor. As it is not, therefore, to be found in the laws which bound the production of wealth, it must be sought in the laws which govern distribution. To them let us turn.

But at least we have narrowed the field of inquiry. The problem of low wages cannot be explained by the laws of production of wealth, so the explanation must involve the distribution of wealth.

It will be necessary to review in its main branches the whole subject of the distribution of wealth. To discover the cause which, as population increases and the productive arts advance, deepens the poverty of the lowest class, we must find the law which determines what part of the produce is distributed to labor as wages. To find the law of wages, or at

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least to make sure when we have found it, we must also determine the laws which fix the part of the produce which goes to capital and the part which goes to landowners, for as land, labor, and capital join in producing wealth, it is between these three that the produce must be divided. What is meant by the produce or production of a community is the sum of the wealth produced by that community—the general fund from which, as long as previously existing stock is not lessened, all consumption must be met and all revenues drawn. As I have already explained, production does not merely mean the making of things, but includes the increase of value gained by transporting or exchanging things. There is a produce of wealth in a purely commercial community, as there is in a purely agricultural or manufacturing community; and in the one case, as in the others, some part of this produce will go to capital, some part to labor, and some part, if land have any value, to the owners of land. As a matter of fact, a portion of the wealth produced is constantly going to the replacement of capital, which is constantly consumed and constantly replaced. But it is not necessary to take this into account, as it is eliminated by considering capital as continuous, which, in speaking or thinking of it, we habitually do. When we speak of the produce, we mean, therefore, that part of the wealth produced above what is necessary to replace the capital consumed in production; and when we speak of interest, or the return to capital, we mean what goes to capital after its replacement or maintenance.

To be sure when we have found it, we must also find the laws which determine which part goes to capital and which part to landowners.

"Production" means the wealth produced by the community. It includes the increase in value gained by transport or exchange.

Production excludes the portion of wealth which goes to replacement of capital.

It is, further, a matter of fact, that in every community which has passed the most primitive stage some portion of the produce is taken in taxation and consumed by government. But it is not necessary, in seeking the laws of distribution, to take this into consideration. We may consider taxation either

We will delay consideration of taxation

and the costs of monopoly until we have discovered the laws of distribution.

as not existing, or as by so much reducing the produce. And so, too, of what is taken from the produce by certain forms of monopoly, which will be considered in a subsequent chapter (Chap. IV), and which exercise powers analogous to taxation. After we have discovered the laws of distribution we can then see what bearing, if any, taxation has upon them.

The current political economy does not correctly apprehend these laws, as may be seen, in the first place, from the terminology employed.

We must discover these laws of distribution for ourselves—or, at least, two out of the three. For, that they are not, at least as a whole, correctly apprehended by the current political economy, may be seen, irrespective of our preceding examination of one of them, in any of the standard treatises.

This is evident, in the first place, from the terminology employed.

All the politico-economic works acknowledge the three factors of production: land, labor, and capital. Rent is the share of production going to the landowner, and wages the share for labor. But as to the share of production going to the owner of capital, there is ambiguity and confusion.

In all politico-economic works we are told that the three factors in production are land, labor, and capital, and that the whole produce is primarily distributed into three corresponding parts. Three terms, therefore, are needed, each of which shall clearly express one of these parts to the exclusion of the others. Rent, as defined, clearly enough expresses the first of these parts—that which goes to the owners of land. Wages, as defined, clearly enough expresses the second—that part which constitutes the return to labor. But as to the third term—that which should express the return to capital there is in the standard works a most puzzling ambiguity and confusion.

They confuse interest with profits.

Of words in common use, that which comes nearest to exclusively expressing the idea of return for the use of capital, is interest, which, as commonly used, implies the return for the use of capital, exclusive of any labor in its use or management, and exclusive of any risk, except such as may be involved in the security. The word profits, as commonly used, is almost synonymous with revenue; it means a gain, an amount received in excess of an amount expended, and frequently includes receipts that are properly rent; while it nearly always includes receipts which are properly wages, as well as compensations for the risk peculiar to the various uses of capital. Unless extreme violence is done to the meaning of the word, it cannot, therefore, be used in political economy to signify that share of the produce which goes to capital, in contradistinction to those parts which go to labor and to landowners.

The word "profits" is understood by the standard works of political economy to include wages, and compensation for risk, as well as interest.

Now, all this is recognized in the standard works on political economy. Adam Smith well illustrates how wages and compensation for risk largely enter into profits, pointing out how the large profits of apothecaries and small retail dealers are in reality wages for their labor, and not interest on their capital; and how the great profits sometimes made in risky businesses, such as smuggling and the lumber trade, are really but compensations for risk, which, in the long run, reduce the returns to capital so used to the ordinary, or below the ordinary, rate. Similar illustrations are given in most of the subsequent works, where profit is formally defined in its common sense, with, perhaps, the exclusion of rent. In all these works, the reader is told that profits are made up of three elements—wages of superintendence, compensation for risk, and interest, or the return for the use of capital.

Thus, neither in its common meaning nor in the meaning expressly assigned to it in the current political economy, can profits have any place in the discussion of the distribution of wealth between the three factors of production, Either in its common meaning or in the meaning expressly assigned to it, to talk about the distribution of wealth into rent, wages, and profits is like talking of the division of mankind into men, women, and human beings.

And therefore, "profits" is a very different concept from "interest."

Yet this, to the utter bewilderment of the reader, is what is done in all the standard works. After formally decomposing

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profits into wages of superintendence, compensation for risk, and interest—the net return for the use of capital—they proceed to treat of the distribution of wealth between the rent of land, the wages of labor, and the PROFITS of capital.

I doubt not that there are thousands of men who have vainly puzzled their brains over this confusion of terms, and abandoned the effort in despair, thinking that as the fault could not be in such great thinkers, it must be in their own stupidity. If it is any consolation to such men they may turn to Buckle's "History of Civilization," and see how a man who certainly got a marvelously clear idea of what he read, and who had read carefully the principal economists from Smith down, was inextricably confused by this jumble of profits and interest. For Buckle (Vol. 1, Chap. 11, and notes) persistently speaks of the distribution of wealth into rent, wages, interest, and profits.

And this is not to be wondered at. For, after formally decomposing profits into wages of superintendence, insurance, and interest, these economists, in assigning causes which fix the general rate of profit, speak of things which evidently affect only that part of profits which they have denominated interest; and then, in speaking of the rate of interest, either give the meaningless formula of supply and demand, or speak of causes which affect the compensation for risk; evidently using the word in its common sense, and not in the economic sense they have assigned to it, from which compensation for risk is eliminated. If the reader will take up John Stuart Mill's "Principles of Political Economy," and compare the chapter on Profits (Book 11, Chap. 15) with the chapter on Interest (Book III, Chap. 23), he will see the confusion thus arising exemplified in the case of the most logical of English economists, in a more striking manner than I would like to characterize.

Now, such men have not been led into such confusion of thought without a cause. If they, one after another, have followed Dr. Adam Smith, as boys play "follow my leader," jumping where he jumped, and falling where he fell, it has been that there was a fence where he jumped and a hole where he fell.

The difficulty from which this confusion has sprung is in the preaccepted theory of wages. For reasons which I have before assigned, it has seemed to them a self-evident truth that the wages of certain classes of laborers depended upon the ratio between capital and the number of laborers. But there are certain kinds of reward for exertion to which this theory evidently will not apply, so the term wages has in use been contracted to include only wages In the narrow com-mon sense. This being the case, if the term interest were used, as consistently with their definitions it should have been used, to represent the third part of the division of the produce, all rewards of personal exertion, save those of what are commonly called wage-workers, would clearly have been left out. But by treating the division of wealth as between rent, wages, and profits, instead of between rent, wages and Interest, this difficulty is glossed over, all wages which will not fall under the preaccepted law of wages being vaguely grouped under profits, as wages of superintendence.

This confusion seems to have sprung from theory that <u>some</u> wages come from capital.

To read carefully what economists say about the distribution of wealth is to see that, though they correctly define it, wages, as they use it in this connection, is what logicians would call an undistributed term—it does not mean all wages, but only some wages—viz., the wages of manual labor paid by an employer. So other wages are thrown over with the return to capital, and included under the term profits, and any clear distinction between the returns to capital and the returns to human exertion thus avoided. The fact is that the current political economy fails to give any clear and consistent

So <u>other</u> wages get thrown over with returns to capital, under the term profits.

account of the distribution of wealth. The law of rent is clearly stated, but it stands unrelated. The rest is a confused and incoherent jumble.

The standard works never bring together the laws of distribution, so it is not apparent that they are uncoordinated.

The very arrangement of these works shows this confusion and inconclusiveness of thought. In no politicoeconomic treatise that I know of are these laws of distribution brought together, so that the reader can take them in at a glance and recognize their relation to each other; but what is said about each one is enveloped in a mass of political and moral reflections and dissertations. And the reason is not far to seek. To bring together the three laws of distribution as they are now taught, is to show at a glance that they lack necessary relation.

The laws of the distribution of wealth are obviously laws of proportion, and must be so related to each other that any two being given the third may be inferred. For to say that one of the three parts of a whole is increased or decreased, is to say that one or both of the other parts is, reversely, decreased or increased. If Tom, Dick, and Harry are partners in business, the agreement which fixes the share of one in the profits must at the same time fix either the separate or the joint shares of the other two. To fix Tom's share at forty per cent. is to leave but sixty per cent. to be divided between Dick and Harry. To fix Dick's share at forty per cent. and Harry's share at thirty-five per cent. is to fix Tom's share at twenty-five per cent.

But if we fish them out from the standard works, we find the accepted laws of distribution to be:

But between the laws of the distribution of wealth, as laid down in the standard works, there is no such relation. If we fish them out and bring them together, we find them to be as follows:

<u>Wages</u> are determined by the ratio between the amount of capital devoted to the payment of labor,

Wages are determined by the ratio between the amount of capital devoted to the payment and subsistence of labor and the number of laborers seeking employment.

and the number of laborers.

Rent is determined by the margin of cultivation; all lands yielding as rent that part of their produce which exceeds what an equal application of labor and capital could procure from the poorest land in use.

Rent is determined by the margin of cultivation.

Interest is determined by the equation between the demands of borrowers and the supply of capital offered by lenders. Or, if we take what is given as the law of profits, it is determined by wages, falling as wages rise and rising as wages fall—or, to use the phrase of Mill, by the cost of labor to the capitalist.

Interest is determined by wages, rising as wages fall.

The bringing together of these current statements of the laws of the distribution of wealth shows at a glance that they lack the relation to each other which the true laws of distribution must have. They do not correlate and co-ordinate. Hence, at least two of these three laws are either wrongly apprehended or wrongly stated. This tallies with what we have already seen, that the current apprehension of the law of wages, and, inferentially, of the law of interest, will not bear examination. Let us, then, seek the true laws of the distribution of the produce of labor into wages, rent, and interest. The proof that we have found them will be in their correlation—that they meet, and relate, and mutually bound each other.

Bringing these "laws" together shows that they do not correlate. So at least two of them must be incorrect.

Let us seek the true laws of distribution, which will mutually bound each other.

With profits this inquiry has manifestly nothing to do. We want to find what it is that determines the division of their joint produce between land, labor, and capital; and profits is not a term that refers exclusively to any one of these three divisions. Of the three parts into which profits are divided by political economists—namely, compensation for risk, wages of superintendence, and return for the use of capital—the latter falls under the term interest, which includes all the returns for the use of capital, and excludes everything else;

"Profits" has nothing to do with this inquiry.

wages of superintendence falls under the term wages, which includes all returns for human exertion, and excludes everything else; and compensation for risk has no place whatever, as risk is eliminated when all the transactions of a community are taken together. I shall, therefore, consistently with the definitions of political economists, use the term interest as signifying that part of the produce which goes to capital.

To recapitulate:

In summary: land, labor and capital receive shares of production as rent, wages, and interest. The concepts are mutually exclusive although any one person may receive income from one, two, or all three of these sources.

Land, labor, and capital are the factors of production. The term land includes all natural opportunities or forces; the term labor, all human exertion; and the term capital, all wealth used to produce more wealth. In returns to these three factors is the whole produce distributed. That part which goes to land owners as payment for the use of natural opportunities is called rent; that part which constitutes the reward of human exertion is called wages; and that part which constitutes the return for the use of capital is called interest. These terms mutually exclude each other. The income of any individual may be made up from any one, two, or all three of these sources; but in the effort to discover the laws of distribution we must keep them separate.

Living in a society where a capitalist generally rents land and hires labor, political economists have been led to look upon capital as the prime factor in production.

Let me premise the inquiry which we are about to undertake by saying that the miscarriage of political economy, which I think has now been abundantly shown, can, it seems to me, be traced to the adoption of an erroneous standpoint. Living and making their observations in a state of society in which a capitalist generally rents land and hires labor, and thus seems to be the undertaker or first mover in production, the great cultivators of the science have been led to look upon capital as the prime factor in production, land as its instrument, and labor as its agent or tool. This is apparent on every page—in the form and course of their reasoning, in the character of their illustrations, and even in their choice of terms. Everywhere capital is the starting point, the capitalist the central figure. So far does this go that both Smith and Ricardo use the term "natural wages" to express the minimum upon which laborers can live; whereas, unless injustice is natural, all that the laborer produces should rather be held as his natural wages. This habit of looking upon capital as the employer of labor has led both to the theory that wages depend upon the relative abundance of capital, and to the theory that interest varies inversely with wages, while it has led away from truths that but for this habit would have been apparent. In short, the misstep which, so far as the great laws of distribution are concerned, has led political economy into the jungles, instead of upon the mountain tops, was taken when Adam Smith, in his first book, left the standpoint indicated in the sentence, "The produce of labor constitutes the natural recompense or wages of labor," to take that in which capital is considered as employing labor and paying wages.

But when we consider the origin and natural sequence of things, this order is reversed; and capital instead of first is last; instead of being the employer of labor, it is in reality employed by labor. There must be land before labor can be exerted, and labor must be exerted before capital can be produced. Capital is a result of labor, and is used by labor to assist it in further production. Labor is the active and initial force, and labor is therefore the employer of capital. Labor can be exerted only upon land, and it is from land that the matter which it transmutes into wealth must be drawn. Land therefore is the condition precedent, the field and material of labor. The natural order is land, labor, capital; and, instead of starting from capital as our initial point, we should start from land.

But when we consider the original and natural sequence of things, capital is, in reality not the employer of labor, but employed by labor.

Capital is not a necessary factor in production. Therefore the law of rent and law of wages must correlate without reference to the law of capital.

There is another thing to be observed. Capital is not a necessary factor in production. Labor exerted upon land can produce wealth without the aid of capital, and in the necessary genesis of things must so produce wealth before capital can exist. Therefore the law of rent and the law of wages must correlate each other and form a perfect whole without reference to the law of capital, as otherwise these laws would not fit the cases which can readily be imagined, and which to some degree actually exist, in which capital takes no part in production. And as capital is, as is often said, but stored-up labor, it is but a form of labor, a subdivision of the general term labor; and its law must be subordinate to, and independently correlate with, the law of wages, so as to fit cases in which the whole produce is divided between labor and capital, without any deduction for rent. To resort to the illustration before used: The division of the produce between land, labor and capital must be as it would be between Tom, Dick, and Harry, if Tom and Dick were the original partners, and Harry came in but as an assistant to and sharer with Dick.