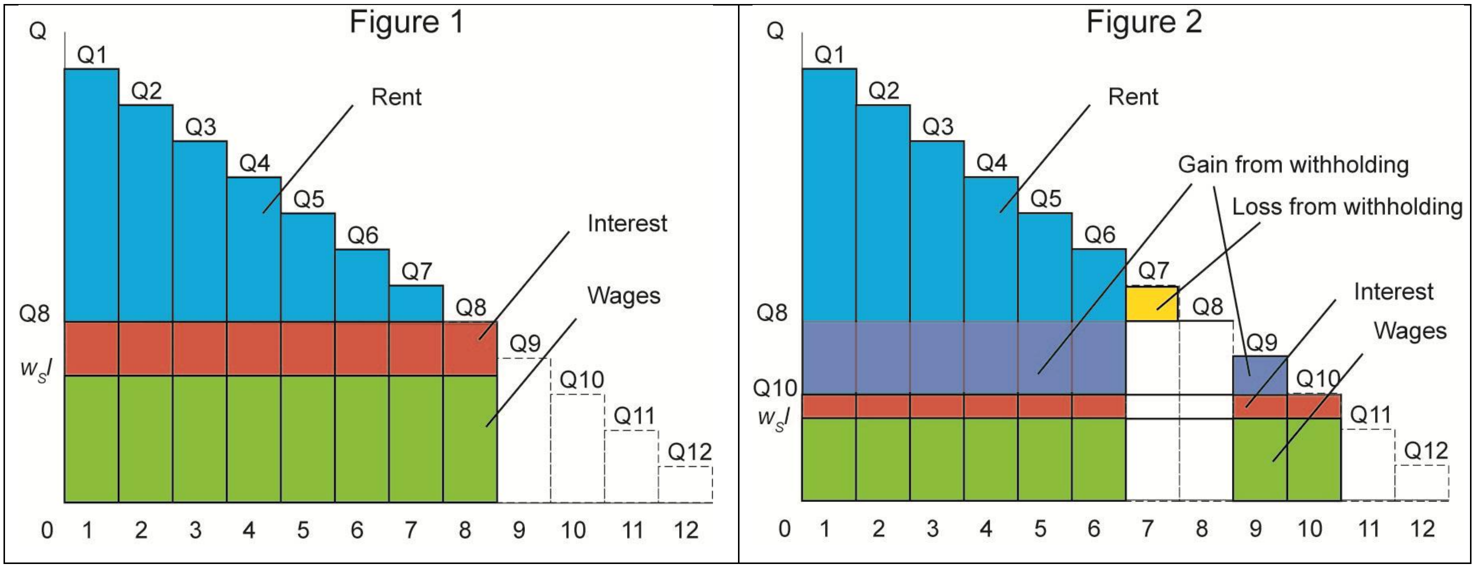
The Classical Economists' Theory of Income Distribution; Henry George's Modified Theory



I. The Classical Economists

The best-known "classical" economists are Adam Smith (1723-1790; *Wealth of Nations*, 1776); Thomas Malthus (1766-1834, *Essay on the Principle of Population*, 1798-1826); David Ricardo (1772-1823, *Principles of Political Economy and Taxation*, 1817, 1821); and John Stuart Mill (1806-1873, *Principles of Political Economy*, 1848-1865). Continuing the classical tradition with their own twists were Henry George (1839-1897, *Progress and Poverty*, 1879); and Karl Marx, *Capital*, 1867+, English translation, 1890).

II. The Classical Economic System

The classical economists recognized three "factors" required in all production: land, labor and capital. The factors corresponded to three social classes: landowners, workers, and capitalists. Landowners collect "rent", workers receive "wages", and capitalists earn "interest" on funds they "advance" to pay wages before production is completed. These funds are therefore called the "wage fund" (or "wages fund"). The classical economists wanted to figure out what share of national income ("wealth" in their terminology) went to each class.

David Ricardo came up with an ingenious model, based on agriculture. Assume we can identify "marginal land"—land that's just barely worth cultivating. No one would pay rent for such land. The production of that land must just equal the cost of cultivation: wages plus interest. Therefore, rent on better quality land must equal the difference between output of that land, and output of marginal land. Think of it this way: if you're a farmer, how much more would you be willing to pay to cultivate good land as opposed to marginal land? Obviously, the difference after all costs. That's rent. It's pure, unearned income, merely for the fact of ownership.

But what about wages and interest? Ricardo assumed wages were at "subsistence" –just enough to keep workers and their families alive. By elimination, that left interest, which had to be the production of marginal land minus the wages needed to cultivate it. On an annual basis, the rate of interest became the annual amount of interest divided by the annual wage bill.

III. The Basic Ricardian System

Figure 1 shows 12 plots of land, of quality ranging from high to low. Assuming the application of a unit of labor, "l" to each plot, the plots can produce output Q_1 through Q_{12}. If plot number 8 is the "marginal" plot of land, and the subsistence wage is w_s, then $w_s l$ is the wage bill on the marginal plot and $W = 8w_s l$ is the wage fund. Since there is no rent on the marginal plot, interest must be $Q_8 - w_s l$. That gives us the interest rate: $i = \frac{Q_8 - w_s l}{w_s l} = \frac{Q_8}{w_s l} - 1$. So, given w_s, the interest rate is determined on marginal land. As shown in Figure 1, the landlord gets the rent (blue), the workers get the wages (green) and the capitalist gets the interest (brown).

IV. Weakness of the Ricardian System

The Ricardian system depends on our knowing the subsistence wage, w_s. Alternatively, it depends on our knowing the annual wage bill, or wage fund, W, and dividing it by L, the total labor supply, to get a fixed wage, w' (which may be greater than subsistence). However, as both Smith and Ricardo clearly recognized, "subsistence" is a very vague concept, dependent more on habit and culture than any absolute nutritional standard. Moreover, it may increase as an economy's prosperity increases. Dividing W by L doesn't improve precision, as both W and L also change over time.

The Ricardian system also doesn't recognize that not only must capitalists advance wages to workers—the wage fund—they must also advance rent to landlords, who usually demand payment ahead of production. That makes it more complicated to estimate interest, since we need to know not only the annual wage bill, but also the annual rent bill.

V. George's Modification of the Ricardian System.

George did not assume a given subsistence wage, or a wage derived from dividing W by L. Instead, he said that the wage is determined by what a man can earn by working with minimal capital on land that is freely available, that is, marginal land. That's so, George says, because no man would voluntarily work for hire if he could earn as much or more working for himself. To put it more formally, the wage is determined by the marginal product of labor and capital on marginal land. By arbitrage, this simultaneously determines all wages. In making this argument, George originated the marginal productivity theory of wages, picked up by the neoclassical economists who followed.

Moreover, George says, *the quality of marginal land is not a given,* as Ricardo assumes. Rather, when large landholders keep tracts of good quality land out of use, or in low use, they force the margin of production out onto lower quality land, at once increasing rent and lowering wages. In modern terms, the greater the concentration of land ownership, the worse the quality of marginal land available to the poor. This pattern is quite obvious in Latin America today, where giant haciendas occupy the best land, often just for grazing cattle, while the peasants scratch out a living on steep eroding hillsides.

VI. Consequences of Land Withholding—Figure 2.

Figure 2 is identical to Figure 1, except that we assume that a single landlord owns the eight highest quality plots of land. That makes him a land monopolist. He does the logical thing for a monopolist; he holds land out of use. In this case, he holds plots 7 and 8 out of use. Look what happens. Labor is forced out onto plots 9 and 10, and the combination of wage and interest is forced down from Q_8 to Q_{10}. Workers and capitalists lose. But the landlord gains. In this diagram, he gains (Q_8-Q_{10}) on plots 1 through 6, and loses only the bit of rent he would have gotten on plot 7. The output of the economy falls by (Q_7+Q_8) – (Q_9+Q_{10})—so workers and capitalists lose more than the landlord gains. (The owner of plot 9 also gains from when wages are forced down; his previously sub-marginal land now earns a bit of rent!)

However, we will get the same result if each plot belongs to a different owner. All that's needed is for one or more of the owners of better quality land to hold some out of use, whatever the motivation.

VII. Land Withholding, Speculation, and Inequality,

Living in San Francisco in the 1860's and '70's, George witnessed something the British classical economists could never have imagined: the California land rush. Firsthand, George saw how Southern Pacific Railroad and east coast absentees snapped up large tracts of fine land and held it off-limits to incoming settlers—forcing them to accept poorer quality, more remote land. In San Francisco itself, he saw the same phenomenon: valuable land held out of use in the form of vacant lots or lots with only "miserable shanties in the midst of costly buildings." George called the land withholders "speculators," for quite surely they acquired land expecting its value to increase dramatically as population poured into California.

However "speculation" doesn't explain land withholding. Most of the withholders are not monopolists in the sense of deliberately keeping land out of use. Even if they bought land for speculation, why is it, as George says, they "cannot or will not use or improve" the land themselves? Why not, while they wait for the price to rise, get some income by renting to someone who will use it? Moreover, the world is full of valuable idle land that does not belong to speculators. So speculation can't be a universal explanation.

Withholders have one key trait in common: they are rich enough to afford withholding. They can't be bothered to manage their property, often because they are absentees, or they actually prefer to keep the land open. Think of medieval lords of the manor galloping through their forest preserves in hot pursuit of deer or boar—while their gamekeepers hang peasants caught poaching rabbits.

George's "remedy", the tax on land value, captures land rent. It goes right to the root cause of withholding: it raises the cost of keeping good land idle. It also goes right to the root of inequality in land ownership—which is what made George so dangerous to the establishment.