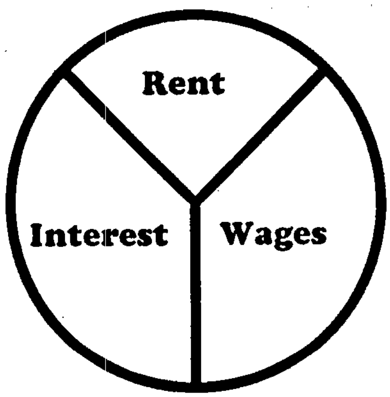
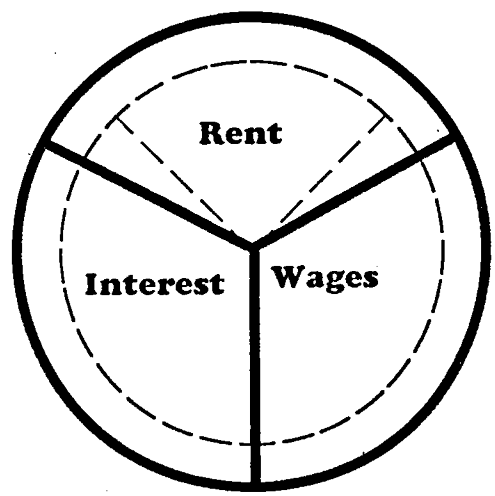
The Fabulous Wealth Pie - I

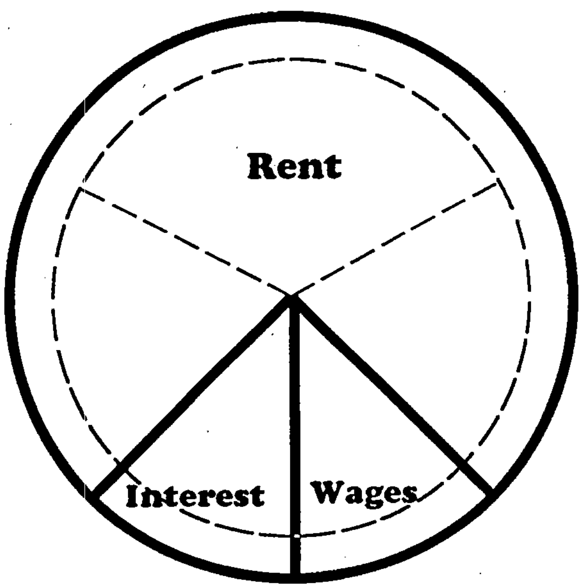
In a primitive economy, where land is freely available, and people use only those simple tools they can make themselves, there is not really any question of the distribution of wealth. Whatever each person produces is kept; economically, that's called wages. Of course, such individual producers do not get much benefit from cooperation and technology, so not a whole lot gets produced.



As population increases, rent emerges, because all the better land becomes privately held, and workers are compelled to pay if they want to use it. The amount of rent (and, therefore, the amounts of wages and interest) depend on the amount of wealth that labor and capital can produce where the land is free (the margin of production). Anything over that amount goes to the landowner as rent.

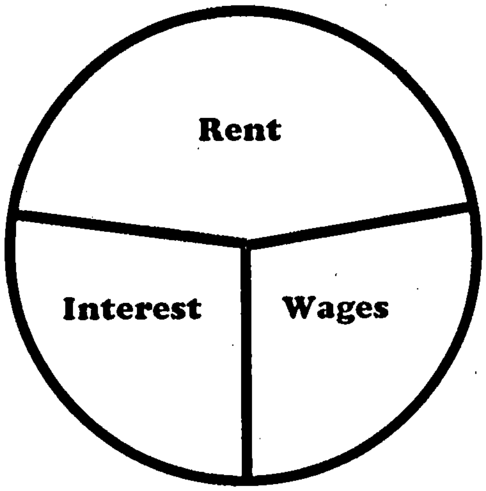
As population increases still further, the output of wealth rises. This causes more land to be taken into private ownership. The remaining free land is less well-suited for production and yields less wealth. So, the workers' free-land alternative is not as attractive as it was before, and rent can take a greater **proportion** of the total. Notice, though, that the **amount** of wages and interest can be greater (the sizes of the pie-slices are greater) even though a smaller **proportion** of the total wealth goes to wages and interest.



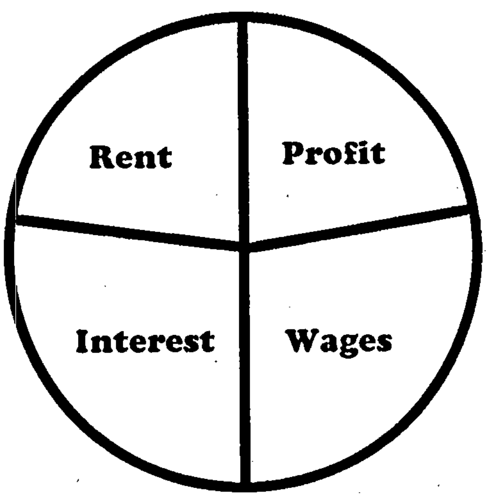


Eventually, as population keeps growing and production keeps increasing, all the free land will be taken by private owners - even though they will not **use** all of it. They will tend to take more than they can use now, holding the land in anticipation of its increase in value! Now, labor and capital are denied a free-land alternative for self-employment, and the amount of wealth taken by rent increases precipitously.

The Fabulous Wealth Pie - II



According to the classical economists, there are three factors of production. Land, labor, and capital are distinct and mutually exclusive. Every economic actor falls into one of the three categories. Therefore, the total of the three factor payments (rent, wages, and interest) adds up to 100 per cent of the wealth produced. This scheme is very useful if we wish to understand the distribution of wealth. If the three factors are clearly distinguishable, then it is possible to unambiguously determine what part of production goes to each. It is possible, in other words, to formulate natural laws of distribution.

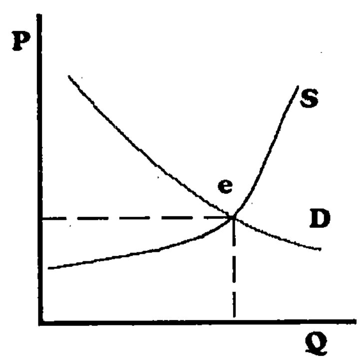


Modern economists, however, have introduced a **four-factor** model. Henry George defines labor as **all human exertion, physical and mental, in the production of wealth.** The four-factor model of distribution essentially separates the function of labor into two categories, labor (implying work for pay, without any particular decision-making input) and **entrepreneurship**. The functions of entrepreneurship are management, decision-making, and, especially, **risk-taking**. The corresponding factor payment for entrepreneurship is named **profit**.

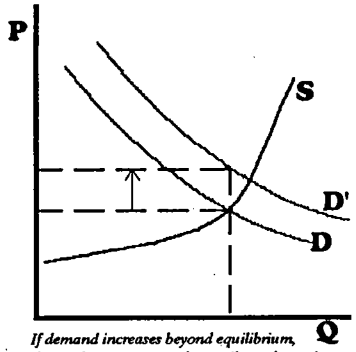
We can see the usefulness of the three-factor model - what then is the four-factor model good for? Basically, it is useful for analyzing business decisions, in which the object is to maximize **profit** - and therefore somewhat useful in understanding an aggregate economy whose individual actors make decisions based on profits. However, it is **not** a model of the distribution of wealth. Instead, it is a model of the distribution of **costs** - the costs the entrepreneur incurs in deciding how to run a business.

To show why these two things are different, we'll have to briefly explore the theory of profit. In the effort to clarify terms, economists make a distinction between the normal conversational sense of the word, which is called **accounting profits**, and the more precise sense of **economic profits**. Accounting profit is simply what a business has left after it pays its expenses. The idea of economic profit, however, incorporates choices made in the allocation of scarce resources, and therefore must consider the **opportunity costs** of various investments. A business's economic profit amounts to the difference between its net receipts and **the most productive alternative use of its resources**. Economic profits, then, could be positive or negative. In fact, a business could make an accounting profit (have money left after paying all its expenses) and yet make a **negative** economic profit (because alternate uses of its land, labor or capital would have yielded a higher return.)

If economic profit is what is gained in excess of opportunity costs, then it has the character of a residual or **surplus.** In a perfectly competitive market there would be no economic profit. That is to say, the best available alternative uses of productive factors would yield a perfectly competitive return - there would be no difference, and hence, no surplus. So it follows that profit arises from some form of interference with perfect competition. Economists identify two main sources of this interference: disequilibrium effects, and monopoly effects.

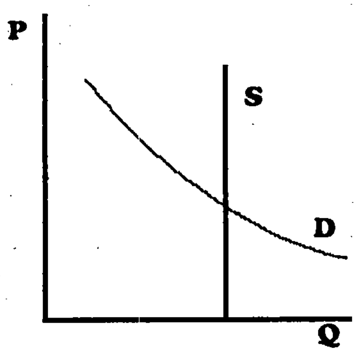


In any market, the tendency is for prices to move toward an equilibrium in which the quantity supplied equals the quantity demanded. This is represented by the intersection of the supply and demand curves in the familiar graph. However, although markets are always tending **toward** equilibrium, markets are affected by many forces and are very seldom actually **at** quilibrium at any given point in time. The task of the entrepreneur in a competitive market is to supply the product at a time of greatest demand. (And it is the task of marketers to keep this demand high for as long as possible, delaying the eventual return to equilibrium.) While demand for a good is at a point above equilibrium, the sale of that good will tend to bring a better return than the sale of goods whose prices are at or below equilibrium. Thus, resourceful entrepreneurs can make use of disequilibrium to gain profits. As long as markets remain competitive, there is no harm in this; in fact, everyone benefits from it.



If demand increases beyond equilibrium, the producer gets a surplus until supply catches up!

The other source of profit is **permanent** (or at least, long-term) impediments to competition: monopolies. Something sells at a monopoly price if the seller can get what ever the buyer is willing to pay rather than go without the thing, which happens if the item in question is **fixed in supply**. This is represented by a vertical, straight supply curve. The supply is always the same; the price is controlled by demand only. The term for profits on items that are fixed in supply is **economic rent.** Of course, the most important and pervasive source of economic rent is **land.**

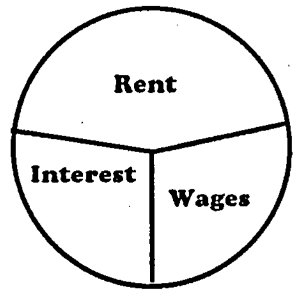


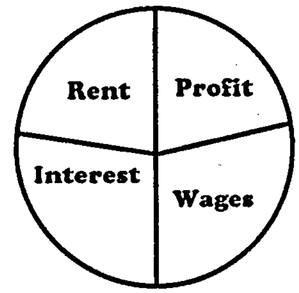
Thus, we see that of the total profit in the economy, part comes from the temporary benefits of disequilibrium, and part comes from economic rent.

Is It Profit, or Is It Rent?

Now: this insight - that part of economic profit comes from monopoly - helps to explain a few puzzling things about our wealth pies. In particular there is confusion about the role of land in the economy. Some say that land is not really a monopoly good, because different landowners compete for buyers or renters who want to put their land to use. If that were true, then we could expect the land market to tend toward allocating land to its highest and best economic use, which our land market clearly does not do. The fact is that land - in other words, all natural opportunities **without** buildings or improvements - is fixed in supply. It does sell for whatever the buyer is willing to give rather than go without using it. And, because owners usually expect land's value to rise, land is sold at a higher price than is justified by the present demand for its use. Land is sold at a **speculative premium.**

Where should the income from land (rent) be classified, according to our allocative scheme? It is the return to a factor that is fixed in supply, so it ought to be called **rent.** Yet it is also a return for risk-taking and entrepreneurial decisions about investing in land and disposing of it. So, in the four-factor scheme of things, it ought to be called **profit.**





In most economic analysis today the lion's share of the returns from land are classed as profit. This is why many economists consider land rent to be an insignificant factor in the economy. For example, according to the Department of Commerce, income distribution in the U.S. between 1976 and 1980 was as follows:

Wages and salaries	74.9%
Proprietors' income	6.2%
Corporate profits	8.5%
Interest	8.5%
Rent	1.9%

Clearly, these are breakdowns according to accounting categories, and they have little or nothing to do with the distribution of wealth in society. Can we really believe that less than two per cent of national income goes to the owners of land?!?

Our three-factor model of distribution can help to resolve this conundrum.

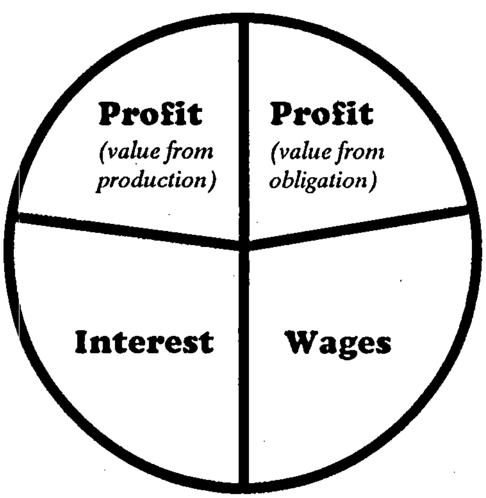
In the classical model, labor is defined as all human exertion in production, whether it is **physical or mental.** In this conception of things, risk-taking and entrepreneurial skill come under the heading of labor. On the other hand, **rent** is defined as income from the ownership of land (or, of other things that are fixed in supply, like unique works of art). These two factors are clearly separable. In the three-factor model there need be no confusion about what payments are rents and what payments are profits. In the four-factor model, the question never really comes up. The whole point of the four-factor model is to understand the ways in which profit is maximized by economic actors; the **source** of profits is far less important.

Is it possible to tell how much of the income from land is due to entrepreneurial activity and how much is pure rent? Yes, there is. A competitive market exists which sets values for risk-taking: it is called insurance. It is possible to pay to be protected from the possibility of losing your shirt by making unwise investments.

Aside from risk, there is also the labor of sales and management to be considered. Henry George suggested a way to deal with this in *Progress & Poverty.* Recognizing that some labor is exerted in the buying, selling, and letting of land, George proposed that the community not take 100% of the rent of land. He suggested leaving a small, but sufficient percentage to the owner as a compensation for the labor involved in allocating the land to use.

Beyond those two things, however - which are legitimate returns to labor - the rest of the income from land ownership is economic rent.

If we are looking at society from the four-factor point of view, then we can say that a large part of economic profit comes from the rent of land. Another large part of economic profit comes from the relatively short-term surpluses cause by disequilibrium. These two types of profit can be understood in terms of the classification of **value** that Henry George proposed in **The Science of Political Economy.** The broad spectrum of profits can be divided into surpluses that come from short-term disequilibrium **(value from production)** and those that come from monopoly **(value from obligation)**



But wait a minute!? What happened to the **rent slice** of that last pie? Well, if rent is only one to two per cent of national income, then the rent slice can be considered negligible. But this doesn't mean that **land** is negligible. It simply means that almost all of the income derived from land is considered, for accounting purposes, to be the entrepreneurial **profit** earned from buying and selling land in the marketplace. And profit is, after all, the very engine of the free-market system! This emphasis on the analysis of profit is one important reason why *Progress & Poverty* is considered irrelevant in this day and age.

Economic Definitions

Classical School/ *Progress & Poverty**	**Neoclassical/Current interpretations****
Political Economy: The science which deals with the nature of wealth and the natural laws governing its production and distribution.	**Economics:** The study of how individuals and societies choose among alternative uses of scarce resources to produce goods.
Land: The entire material universe - all natural opportunities - except for human beings and their products.	**Land:** Natural resources that are available without alteration or effort on the part of humans. "Land as a resource includes only original fertility and mineral deposits, topography, climate, water, and vegetation."
Labor: All human exertion, mental or physical, in production.	**Labor:** "Productive contributions of humans who work, which involve both thinking and doing."
Capital: Wealth that is used in production.	**Capital:** "All manufactured resources, including buildings, equipment, machines, and improvements to land."
Entrepreneurship: Risk-taking and decision-making activities; a function of Labor.	**Entrepreneurship:** "The fourth factor of production involving human resources that perform the functions of raising capital, organizing, managing, assembling other factors of production, and making basic business policy decisions. The entrepreneur is a risk-taker.
Rent: That part of wealth which is the return for the use of land. (Or, strictly speaking, payment for any factor that is fixed in supply.)	**Rent:** Payment for the use of land, or for any other factor that is fixed in supply.
Wages: That part of wealth which is the return for labor.	**Wages:** Payment for labor.
Interest: That part of wealth which is the return for the use of capital.	**Interest:** "The payment for current rather than future command over resources; the cost of obtaining credit. Also, the return paid to owners of capital."
Profit: Profit is a concept which is used in making business decisions; it is not an avenue of wealth distribution. The source of profit is ambiguous, and usually mixed - it could come from land, labor, or capital.	**Profit:** **Accounting** profit: "The difference between total revenues and total explicit costs. **Economic** profit: "The difference between total revenues and the opportunity cost of all factors of production."
**Taken from The Henry George School's course in* Fundamental Economics	***Taken from Miller,* Economics Today, *4th ed., 1982, New York, Harper & Row*