

## Chapter 4 The Profit

### 4.1 Definition

Profit is a positive gain from a business operation. The term "profit" like "income" means the difference between revenue and expenses, before taxes. Profit is part of the principles of economics.<sup>1 2</sup>

Economics is a conversation that has been going on for over two hundred years. The conversation includes professional economists, citizens, managers, and others. The conversation began with Adam Smith's book "The Wealth of Nations." Smith's topic: Why do some countries have high standards of living? What makes nations wealthier?

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<sup>1</sup> "In economics, return on capital, also called earnings, minus the costs of maintaining land, labor, and capital. It is also known as net income. Economic theorists generally make a distinction between two types of profit: normal profit, in which the entrepreneur receives the minimal necessary amount to encourage him to open or stay in a particular business; and excess profit, that which exceeds normal profit." The Columbia Encyclopedia, 6<sup>th</sup> Edition. 2001, <http://www.bartleby.com/65/pr/profit.html>

<sup>2</sup> "Profit", in business, the monetary difference between the cost of producing and marketing goods or services and the price subsequently received for those goods or services. Profit is an essential competitive feature of buying and selling in the economic system. The opposite of profit is loss, whereby the cost of producing certain goods or services is higher than the price a buyer is willing to pay for them. Microsoft Encarta Online Encyclopedia 2001, <http://encarta.msn.com>

The profit is a result of combining three main components - land, labour and capital. Land is the original and indestructible powers of the soil - natural resources, such as coal, oil, and metallic ores. Labour is human action and is the resource from which most of us expect to earn our living. Capital consists of all goods produced by human labour, and used in the production of still more goods.

Adam Smith thought that increases in the division of labour were the most important source of increasing productivity. His most famous example was the "pin factory." More generally, when people work cooperatively, doing different jobs that reinforce one another, everybody becomes more productive and better off.

Smith thought that increasing division of labour was the most important source of increasing productivity in the long run. Most modern economists think that it is a technological progress. Really, division of labour and new technologies reinforces one another. For example, new technologies in communication and transportation will create new opportunities for division of labour.

At the beginning of the 19<sup>th</sup> century economists and philosophers used to view the economy via the angle of agriculture, as it was at that time the main field of the economic system. David Ricardo saw the earth as the origin of wealth and profit, and divided it into three categories. The first category is the produce of the earth - all that is derived from its surface by the united application of labour, machinery, and capital. The produce of the earth is divided among three classes of the community; namely, the proprietor of the land, the owner of the stock or capital necessary for its cultivation, and the labourers by whose industry it is cultivated. In different stages of society, the proportions of the whole produce of the earth under the names of rent, profit, and wages, will be essentially different. It depends mainly on the actual fertility of the soil, on the accumulation of capital and population, on the skill, ingenuity, and instruments employed in agriculture.<sup>3</sup>

Ricardo divided the profit into three parts - the "proprietor of the land" meaning the rent, the "owner of the stock or capital" meaning the interest, and the

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<sup>3</sup> Ricardo, David. *Principles of Political Economy and Taxation*, 1817, third edition 1821, preface, McMaster University, Faculty of Social Sciences, <http://socserv2.socsci.mcmaster.ca/~econ/ugcm/3ll3/ricardo/prin/prin1.txt>

"labourers" meaning the wages. The share of the profit of each one of those three, is an economic as well as social issue. The answer depends on the economic system - capitalistic, socialistic, or communistic; on the regime method - democratic or totalitarian; and on the personal point of view.

At the end of the 19<sup>th</sup> century, we can find a sophisticated attitude to the meaning of "profit" which was introduced by Alfred Marshall. "When a man is engaged in business, his profits for the year are the excess of his receipts from his business during the year over his outlay for his business. The difference between the value of his stock of plant, material, etc. at the end and at the beginning of the year is taken as part of his receipts or as part of his outlay, according as there has been an increase or decrease of value. What remains of his profits after deducting interest on his capital at the current rate (allowing where necessary, for insurance) is generally called his earnings of undertaking or management. The ratio in which his profits for the year stand to his capital is spoken of as his rate of profits."<sup>4</sup>

Joseph Schumpeter wrote about this issue at the beginning of the 20<sup>th</sup> century. "We seem to be faced by this alternative: either we are to assume social utility curves,--in which case society must be the sole owner of capital and land, the society is communistic, and no rent or interest will be paid to individuals; or rent and interest are paid, in which case there are no social values, but only individual ones, and society as such does not control production. It may still be held that the final results are the same as they would be if society were in control; and this theory we shall further discuss."<sup>5</sup>

In his book that was published after his death, Schumpeter referred to Ricardo and wrote: "The sum total of the gains of the business class, the theoretical type of which, with the Ricardians, was the farmer."<sup>6</sup>

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<sup>4</sup> Marshall, Alfred. Principles of Economics, An introductory volume, 1890, Book II: Chapter 4 Income, Capital. Universite Paris 1, CHPE Centre d'Histoire de la Pens'e Economique, <http://panoramix.univ-paris1.fr/CHPE/Textes/Marshall/Principles/>

<sup>5</sup> Schumpeter, Joseph. On the Concept of Social Value, Quarterly Journal of Economics, volume 23, 1908-9. Pp. 213-232. <http://socserv2.mcmaster.ca/~econ/ugcm/3ll3/schumpeter/socialval.html>

<sup>6</sup> Schumpeter, Joseph. History of economic analysis, George Allen & Unwin Ltd., sixth printing 1967, p. 645.

#### 4.1.1 Positive and Normative Economics<sup>7</sup>

According to Milton Friedman,<sup>8</sup> positive economics has to do with "what is," while normative economics has to do with "what ought to be." Positive economics is a social science, and as such is subject to the same checks on the basis of evidence as any science. By contrast, normative economics has a moral or ethical aspect, and as such goes beyond what a science can say.

It is true that economics cannot rely on experimental methods to verify its hypotheses, in many cases. However, the same is true of some of the sciences, ranging from astronomy to ecology. These are observational sciences, and so is positive economics.

Let us illustrate the distinction and some of its pitfalls by an example. A person might say, "Everybody ought to be paid the same hourly wage, because it is just that each person should be rewarded in proportion to his labour." This is clearly normative economics, as it has to do with what should be.

Now, a "positive" economist might observe that this rule would be inefficient in the following sense. Some occupations require more training, more effort, or more talent than others or they are more responsible. If these occupations are better rewarded, they will be better performed, and overall productivity of labour will increase as a result. This increase in productivity will be more than enough to pay the higher wages for the skilled, talented, effortful and responsible occupations, with something left over that might make everyone better off. This is positive economics so far as it goes, and like any proposition of positive science, it might be either true or false.

But suppose it is true, and suppose the "positive" economist goes on to say that because equal wages are inefficient, wages should not be equalized. That would be normative, not positive economics, and it would be fallacious. The normative economist can respond with perfect logic that justice is more important than a reduction in output, which may well be quite modest. There is a hidden

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<sup>7</sup> Essential Principles of Economics: A Hypermedia Text in The [journal of Economic Education](http://william-king.www.drexel.edu/top/prin/txt/ECOTOC.html), <http://william-king.www.drexel.edu/top/prin/txt/ECOTOC.html>

<sup>8</sup> Milton Friedman is a conservative social philosopher and economic theorist and statistician.

assumption, and the assumption is that people "ought" to value production over equality of reward, and there is no logical reason why they should not.

What the positive economist can do is spell out the consequences of a rule such as equal pay. This is important, since rules always have consequences that are hard to anticipate. If we understand the consequences, we may want to reconsider our support for the rule. But the rules we propose, and the consequences we are interested in, depend upon our values. Not all consequences are equally important. In the last analysis, positive economics is the servant of normative economics.<sup>9</sup>

In this chapter I will deal with the three "partners" that share the profit and the wealth provided by the earth - the wages of the labourer, the interest on the money (means stock and capital), and the rent for the land. In this chapter, I will not deal with the entrepreneurial profit, that is a surplus over costs.<sup>10</sup>

## 4.2 Wages - Profit for Selling Time (Labour)

The most precious property of man is time. An infant dedicates his time to learn basic skills, a pupil to learn basic studies, and a student and an apprentice to learn a profession. Man should eat, sleep, raise his family, and take care of his health and his lifestyle. The rest of the time may be dedicated to support himself and his family.

One may say that this description does not fit those who should support

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<sup>9</sup> An important point of view is presented by Matthew Josephson in his book *The Robber Barons*. The author describes the Barons in the context of the political, social, and industrial trends of the time. It tells the story of the massive industrialisation of America that occurred in the last quarter of the 19<sup>th</sup> century. It was the greatest boom of them all, generating a giant interlocking system that covered steel, oil, railways, coal, food processing and banking. It describes how they were shaped by the industries they were in, and by the competitive forces set in motion by each other. The book was written in 1934 in the depths of the Great Depression, when many people questioned their faith in the free market system.

<sup>10</sup> "The most important theories of profits may be characterized by the following terms: friction theory, risk theory, differential rent theory. I refer to the discussion of them in *Wesen*, bk. III, and shall not here enter into a critique of them. At the same time J. B. Clark, whose theory is nearest to mine, may be cited here; cf. His *Essential of Economic Theory*." Schumpeter, Joseph. *The Theory of Economic Development, An Inquiry into Profits, Capital, Credit, Interest, and Business Cycle*, Harvard University Press, 1959, 6<sup>th</sup> printing, p. 128.

themselves, even if they have to neglect their other basic needs. This criticism is partly correct for a land leaser in feudal regime, an employee in a factory at the beginning of the industrial revolution, a slave, and others that do not live in modern democratic countries, but is correct for a man that was born free and is capable to choose.

An employee can sell this precious property to his employer; a service provider can sell it to his clients, and a merchant to his customers. No matter who is the seller and who is the buyer, the time is sold for the benefit of a profit.

Ricardo described the labour and the wages in a similar way: "Labour, like all other things which are purchased and sold, and which may be increased or diminished in quantity, has its natural and its market price. The natural price of labour is that price which is necessary to enable the labourers, one with another, to subsist and to perpetuate their race, without either increase or diminution... The market price of labour is the price, which is really paid for it, from the natural operation of the proportion of the supply to the demand; labour is dear when it is scarce, and cheap when it is plentiful. However, much the market price of labour may deviate from its natural price, it has, like commodities, a tendency to conform to it."<sup>11</sup>

Adam Smith discussed the influence between the demand for labour, the cost of life, the direct tax upon the wages, and the wages of the workman. "The ordinary or average price of provisions determines the quantity of money, which must be paid to the workman in order to enable him, one year with another, to purchase this liberal, moderate, or scanty subsistence. While the demand for labour and the price of provisions, therefore, remain the same, a direct tax upon the wages of labour can have no other effect than to raise them somewhat higher than the tax."<sup>12</sup>

Most of those dilemmas belong to the past. In the western countries, labourers are

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<sup>11</sup> Ricardo, David. The Iron Law of Wages, 1817, Fordham University, Modern History Sourcebook, From The Works of David Ricardo, J. R. McCulloch, ed. (London: John Murray, 1881), pp. 31, 50-58. <http://www.fordham.edu/halsall/mod/ricardo-wages.html>

<sup>12</sup> Smith, Adam. The Wealth of the Nations, book 5, chapter II, article III - Taxes upon the Wages of Labour, p. 25, Bibliomania: Free World Literature online, <http://www.bibliomania.com/2/1/65/112/frameset.html>

members in unions with political influence, and the law protects and sometimes over protects their rights. Yet, those arguments are in use nowadays more than ever.

#### 4.2.1 Karl Marx<sup>13</sup>

Karl Marx saw capitalism as a society divided between two classes, the working class, producers of all value, and the owning and employing class, exploiter of surplus value. For Marx, the fundamental fact about capitalism was the class struggle between the working class and the employing class over surplus value.

Surplus value and exploitation took a specific form in a capitalist society, but had existed long before capitalism. Marx claimed that all history should be thought of as the history of class struggles over surplus value. That is, the theory of surplus value is a theory of history.

No classes or surplus value existed in prehistoric times, however, early societies were undeveloped, and as a result their labour-productivity was so low that they could produce only enough to assure the reproduction of the tribe or band. In these circumstances they practiced "primitive communism."

This was necessary for survival: if each person did not produce according to her or his ability, and share with others according to their needs, the group would not survive as a group, and no individual could survive for long without the group.

Thus there could be no exploitation, and these early societies (Marx guessed) would be equalitarian and free, albeit very poor. There is a good deal of anthropological evidence consistent with Marx' guess on this point.

The earliest historic stages of society Marx spoke of as "slave" societies.<sup>14</sup> Marx

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<sup>13</sup> Essential Principles of Economics: A Hypermedia Text in The [journal of Economic Education](http://william-king.www.drexel.edu/top/prin/txt/ECOTOC.html), <http://william-king.www.drexel.edu/top/prin/txt/ECOTOC.html>

<sup>14</sup> "In the first place, the rise of wages leads to overwork among the workers. The more they want to earn the more they must sacrifice their time and freedom and work like *slaves* in the service of avarice. In doing so, they shorten their lives. But this is all to the good of the working class as a whole, since it creates a renewed demand. This class must always sacrifice a part of itself if it

was thinking of classical Greek and Roman society, in which slavery played a relatively large role; but our evidence suggests that the role of simple slavery varied widely among early civilizations. The basic unit of society was the city, town or village, and stronger communities extracted surplus from weaker ones by threat.

Slavery was just one form that tribute might take, and in many cases slaves were the collective property of the city. Tribute is due from a person as a member of a defeated group to another person as a member of a triumphant group. Tribute is legitimated theft -- the payer renders tribute in order to avoid violent attack, as the slave works to avoid violent attack by her or his master.

This sort of society is hierarchical, in that smaller and weaker towns pay tribute to middling cities that pay, in turn, the larger and stronger cities their tribute. The hierarchy may be reproduced within the city communities, especially the bigger and stronger ones. Emperors and tyrants rule over mere citizens as great towns rule over villages. But not always -- our classical examples of democracies are cities in which the citizen-fighters are equal among themselves, benefiting from the tribute and labour of non-citizen slaves and villagers.

Because agricultural societies can produce a significant surplus over what the farmer must eat to work and survive, tribute and slavery become the basis of life for the non-working class, which includes not only soldiers and rulers but also poets, scholars, scientists, craftsmen, artists, physicians, priests, and philosophers. In brief, the extortion system was the basis of civilization. But that civilization collapsed and was replaced, in many parts of the world, by a new system called "feudalism."<sup>15</sup>

For Marx, the next and intermediate stage was feudalism, well known from

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is to avoid total destruction. " Marx, Karl. Economic and Philosophical Manuscripts, First Manuscript, [Wages of Labour](http://www.marxists.org/archive/marx/works/1844-epm/1st.htm), Marxists Internet Archive: Encyclopedia of Marxism  
<http://www.marxists.org/archive/marx/works/1844-epm/1st.htm>

<sup>15</sup> "For, to our three social reformers, the bourgeois world, based upon the principles of these philosophers, is quite as irrational and unjust, and, therefore, finds its way to the dust-hole quite as readily as *feudalism* and all the earlier stages of society." "Utopian communism", [Encyclopedia of Marxism: Glossary of Terms](http://www.marxists.org/glossary/terms/c/o.htm#utopian-communism),  
<http://www.marxists.org/glossary/terms/c/o.htm#utopian-communism>



European history. In theory, exploitation in feudal society is based on ownership of land. Of course, the landowners have the means of violence, and violence is used to enforce their ownership of land, but it is no longer simply violence to obtain tribute -- rather violence to enforce property in a certain kind of resource.

The stage is then set for an exchange: resource for resource, land for labour. But this exchange can never be equal: the serfs have no means of life in an agrarian society and must offer their labour in exchange for access to land on what terms they can get. Those terms are so poor that landowners become the beneficiaries of "privilege," that is, private law.

Landowners are the state; it makes no sense for the state to pay taxes to itself; therefore landowners pay no taxes. And workers may be deprived of the freedom to move, bound to the land, and even bought and sold little differently than slaves.

At the same time, feudalism is more individualistic than the tribute (slave) society. A village community may still pay tribute, but it is paid to an individual landlord, and increasingly it is a matter of the exchange of labour service for access to land on an individual basis. This individualism in the ruling landowner class correlates with the highly fragmented nature of feudal society, but it also leads to the first real conception of freedom. The landlord is free, a sovereign individual whose relation to others in his class is essentially reciprocal, and this is the concept of freedom that moves modern society.

Feudalism is a class system. There is a class of landlords, and a class of land-less farmers. The landlords do not work at farming. They are fighters, and in theory, it is their job to protect the farmers from any attempt at extortion or enslavement by other fighters.

The compromise between the two classes is that the farmers spend part of their time working on the landlord's land, and in return the village gets access to a supply of land they may work for their own food. In addition to this exchange of land for labour, the landlord "protects" the village and the village supports the landlord's fighting with loyal service. Thus, land is not simply the landlord's property.

The village has rights, and individual villagers have rights in it as members of the

village community. Conversely, the landlord has rights in the labour of the village, and the villager may not be allowed to leave the village community without the landlord's permission. He is then a "serf," and in extreme cases such as that of Russia, the serf's status may be only slightly better than that of a slave. The non-working class of landlords was known as the nobility, or, in a term from Greek societies, aristocracy.

The two old classes, landlords and farmers, now faced a new "middle" class that relied much more on money and markets. The city with a wall, became a bourg (burg) and so the new class were called (in Marxist thinking) bourgeoisie (burgers). The cities were the beginning of capitalism, but at the beginning they were more feudal in their way than capitalist.

Capitalism was emerging, but it required two things. One was the emergence of national states. The national state is, essentially, a feudal city extended to the territory of the nation, with its own paid army of mercenaries or professional national forces, and taxation on individuals to pay for this army.

In England, in the English revolution, a paid national army of the English Republic met the aristocratic army of English feudalism and beat it. When the English monarchy was restored, it simply adopted the army of the republic, red coats and all. In France, the king created the national army. Either way, the existence of a national army meant the divorce of the landlord class from its special function as fighters.

The second step was to eliminate the special rights of the landlords and the village community in land. In France, that took place in the revolution of 1789, when the villagers simply took the land as individual property. In England, the landlord class was transformed into a class of capitalist landowners who rented their land for money.

Thus, feudalism gave way to capitalism. Still, the hand of violence is concealed behind and restrained by a system of property. But property is abstracted. It is property in general -- not in a specific resource, such as land -- that is enforcing by governmental violence, and forms the basis for exploitation. Conversely, the connection between the exploiter and the worker is no longer an exchange of resource for resource, but an exchange of resource (labour) for money.

The exploiting class requires the working class, but the working class does not require exploiters, and eventually will dispense with them, organizing production for its own benefit as a class. This new society is "socialism." Capitalism replaced feudalism through a series of revolutions, in which the class of "capitalists" or "merchants"<sup>16</sup> fought and defeated the class of landlords. The emergence of the new socialist society will be no fewer revolutionaries in all probability. But these new revolutions will mark the end of the historic tale of classes, exploitation and surplus value, and a return to the equality of prehistoric societies -- but without the poverty they had to endure.

### **4.3 Interest - Profit for Using Money, Stock, and Capital**

"Interest" - the fee charged by a lender to a borrower for the use of borrowed money, usually expressed as an annual percentage of the principal; the rate is dependent upon the time value of money, the credit risk of the borrower, and the inflation rate.<sup>17</sup>

The legal definition for "interest" is the financial amount paid by someone else for the use of a person's money, as on a loan or debt, on a savings account in a bank, on a certificate of deposit, promissory note or the amount due on a judgment. Interest is usually stated in writing at the time the money is loaned. There are variable rates of interest, particularly on savings accounts, which depend on funding from the Federal Reserve or other banks and are controlled by the prevailing interest rates on those funds. Maximum interest rates on loans made by individuals are controlled by statute. To charge more than that rate is usury, the penalty for which may be the inability of a creditor to collect through the courts. The interest rates demanded by lending institutions are not so restricted. The law

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<sup>16</sup> "Civilization consolidates and intensifies all these existing divisions of labor, particularly by sharpening the opposition between town and country (the town may economically dominate the country, as in antiquity, or the country the town, as in the middle ages), and it adds a third division of labor, peculiar to itself and of decisive importance: it creates a class which no longer concerns itself with production, but only with the exchange of the products -- the *merchants*." "Division of Labour" [Encyclopedia of Marxism: Glossary of Terms](http://www.marxists.org/glossary/terms/d/i.htm#division-labor), <http://www.marxists.org/glossary/terms/d/i.htm#division-labor>

<sup>17</sup> "Interest", [Investor-words](http://www.investorwords.com/), the biggest, best investing glossary on the web, InvestorGuide.com, Inc. <http://www.investorwords.com/>

of the state sets the maximum legal interest often granted by the courts on judgments. Simple interest is the annual rate charged for a loan, and compound interest includes interest upon interest during the year.<sup>18</sup>

Marshall defined the interest as "The payment made by a borrower for the use of a loan for, say, a year is expressed as the ratio which that payment bears to the loan, and is called interest."<sup>19</sup>

Schumpeter referred to interest as a part of common economic system. "Interest on business loans is nothing but a normal business profit transferred to lenders... normal business profit itself is nothing but the return on the physical means of production, labour's means of subsistence included."<sup>20</sup>

Nicholas Barbon used a special illustration. "Interest is the rent of stock, and is the same as the rent of land. The first, is the rent of the wrought or artificial stock; the latter, of the unwrought or natural stock."<sup>21</sup> Barbon describes the linkage between interest and rent. Another use of interest is the measure of the value of the rent of land. It sets the price in buying and selling of land. He explains the height of the interest. Interest being so high in England, is the cause of the fall of rents.<sup>22</sup>

A historical lesson can be learned from an ancient legal system that intended to protect the peasants from bankruptcy and becoming a feudal society. "Moses, that wise law-giver, who designed that the land divided amongst the Jews, should continue in their families; forbid the Jews to pay interest, well knowing that the

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<sup>18</sup> "Interest", The Real Life Dictionary of the Law, General Publishing Group, Inc.  
<http://dictionary.law.com/>

<sup>19</sup> Marshall, Alfred. Principles of Economics, An introductory volume, 1890, Book II: Chapter 4 Income, Capital. Universite Paris 1, CHPE Centre d'Histoire de la Pens'e Economique,  
<http://panoramix.univ-paris1.fr/CHPE/Textes/Marshall/Principles/>

<sup>20</sup> Schumpeter, Joseph. History of economic analysis, George Allen & Unwin Ltd., 6<sup>th</sup> printing 1967, p. 327.

<sup>21</sup> Barbon, Nicholas. A Discourse of Trade, Of Money, Credit and Interest. London, Printed by Tho. Milbourn for the Author, 1690. McMaster University in Canada, maintained by Robert Dixon in the Economic department of the University of Melbourne,  
<http://melbecon.unimelb.edu.au/het/barbon/trade.txt> Quoted by Schumpeter, Joseph. History of economic analysis, George Allen & Unwin Ltd., sixth printing 1967, p. 329.

<sup>22</sup> *Ibid.*, Of the Chief Causes of the Decay of Trade in England, and Fall of the Rents of Land.

merchants of Tyre, who were to be their near neighbors, would, by lending money at interest, at last get their lands. And that this seems to be the reason, is plain; For the Jews might take interest of strangers, but not pay; for by taking interest, they could not lose their estates."<sup>23</sup>

Whether the interest is high or low, it is the target to attack the money loaner ("loan sharks" in American slang) and to attach them a social stigma.<sup>24</sup>

## 4.4 Rent - Profit for Using Land

### 4.4.1 Definition of Rent

"Rent" is a periodic payment by a tenant for the use of another's property i.e. real estate (land and buildings).<sup>25</sup> The term rent applies as well to the payment for the use of moveable products.

In economics, its meaning is more complex, but since the word rent means any income or yield from an object capable of producing wealth, its limitation to a more special sense is somewhat arbitrary and justified only by a general consensus of opinion and usage.

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<sup>23</sup> *ibid.*

<sup>24</sup> Shakespeare, William. The Merchant of Venice, the character of Shylock.

<sup>25</sup> The term "Rent" is defined by various dictionaries and glossaries: "This is the consideration paid by a tenant to a landlord in exchange for the exclusive use and enjoyment of land, a building or a part of a building. Under normal circumstances, the rent is paid in money and at regular intervals, such as the first of every month. The word has also come to be used as a verb as in to "rent an apartment", although the proper legal term would be to "lease an apartment." Duhaime's Law Dictionary, Duhaime & company, <http://www.duhaime.org/diction.htm>. "The consideration paid for the right to use and possess property. A certain profit in money, provisions, chattels, or labour, issuing out of lands and tenements in retribution for the use." The Lectric Law Library Reference Room, <http://www.lectlaw.com/ref.html>. "Payment, usually monthly, for use of space or property." Investors Words the biggest, best investing glossary on the web, InvestorGuide.com, Inc. <http://www.investorwords.com/> "A fixed, periodic payment made by a tenant of a property to the owner for possession and use, usually by prior agreement of the parties." Buyers' Resource Glossary, <http://homes.inresco.com/Bglossary.html>

The term rent is now ordinarily used in the broad sense and besides the return from land, includes the return from such things as tools, machinery, and houses. Objects are rented for a limited period of time and are generally expected to be returned in their original condition.

The early English writers on economics (16th–18th cent.) used the word to mean interest on a loan, but its economic meaning gradually narrowed to the sense of the return on land. Modern rent doctrine began in the 18th cent.<sup>26</sup>

"The tenure holder, or peasant, owed the seigneur two basic obligations, rent and services. Rents were highly variable, but services were usually still the greater burden. The basic services were agricultural labour on the demesne land, military duty, and craftwork. Agricultural labour, for example, might be calculated as three man-days a week per tenure holding. Since a family on a holding might be quite large, the three days could be divided among several men. Military duty would be highly variable because it would be a simple response to emergency -- ordinarily an 'all hands' response."<sup>27</sup>

The amount of rent paid reflects the devaluation of rental property, the interest paid to the banks to finance the purchase of the property, and the profit of the property owner. In fact, the rental fees are determined by the accepted market value of a rental fee of a similar property and the rate is influenced by supply and demand. Sometimes it can even be determined by the policy of various subsidies given by the state or other local councils that are leasing out similar properties owned by them. Rental rates can also be influenced by legislature, which often puts a ceiling on the rates.

#### **4.4.2 The Theory of the Physiocrats upon Rent**

The physiocrats centered their economic system on land. They believed that rent is measured by the "net product" i.e. the surplus over the cost of production. They

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<sup>26</sup> "Rent", *The Columbia Encyclopedia*, Sixth Edition. 2001.  
<http://www.bartleby.com/65/re/rent.html>

<sup>27</sup> Primitive Culture, the village with internal specialization and exchange, European peasant society, *Encyclopaedia Britannica*, Britannica.com editors,  
<http://www.britannica.com/eb/article?eu=118249&tocid=68791#68791.toc>

believed in a free trade and in land and its products as the only true wealth. Because they identified wealth with fixed material objects, the physiocrats considered rent not as the variable yield from land but as a fixed value, which they called "current price of leases" and "disposable revenue".

Adam Smith attempted to formulate a "natural rate" of rent based on the laws of supply and demand. This rate would be an amount high enough to induce the landowner to keep his land in cultivation and low enough to allow the tenant to subsist. Smith referred to the rent as a profit or interest for the investment of the landlord: "Rent, considered as the price paid for the use of land, is naturally the highest which the tenant can afford to pay in the actual circumstances of the land... The rent of land, it may be thought, is frequently no more than a reasonable profit or interest for the stock laid out by the landlord upon its improvement."<sup>28</sup>

David Ricardo held that demand determined the amount of marginal land under cultivation, and that rent was determined by this margin, which had the highest costs of production. Ricardo attacked Smith for putting rent on the same footing with wages and profits as one of the costs of production. He thought that high or low wages and profits were the cause of high or low prices, while high or low rents were the effect of these prices.

Critics of Ricardian theory, such as Henry George, argued that monopolistic control of rent was the cause of poverty, which could only be cured by converting private rights into public by the medium of a "single tax" on land.

Thomas Malthus described the nature of the rent. "The rent of land may be defined to be that portion of the value of the whole produce which remains to the owner of the land, after all the outgoing belonging to its cultivation, of whatever kind, have been paid, including the profits of the capital employed, estimated according to the usual and ordinary rate of the profits of agricultural stock at the time being."<sup>29</sup>

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<sup>28</sup> Smith, Adam. The Wealth of the Nations, book 1, chapter XI - Of the Rent of Land, p. 203. Electronic Book Company, London, <http://www.elecbook.com/admsmith.zip>

<sup>29</sup> Malthus, T.R. An Inquiry into the Nature and Progress of Rent, and the Principles by which it is regulated, 1815, p. 5, Electric Book Company, London, <http://www.elecbook.com/malrent.zip>, quoted by Ricardo, David. An Essay on Profits, 1815. London: Printed for John Murray, Albemarle Street, 1815, McMaster University, Faculty of Social Sciences, <http://socserv2.socsci.mcmaster.ca/~econ/ugcm/3ll3/ricardo/profits.txt>

Malthus stated that "According to the returns lately made to the Board of Agriculture, the average proportion which rent bears to the value of the whole produce, seems not to exceed one fifth; whereas formerly, when there was less capital employed, and less value produced, the proportion amounted to one fourth, one third, or even two fifths. Still, however, the numerical difference between the price of produce and the expenses of cultivation, increases with the progress of improvement; and though the landlord has a less share of the whole produce, yet this less share, from the very great increase of the produce, yields a larger quantity, and gives him a greater command of corn and labour. If the produce of land be represented by the number six, and the landlord has one fourth of it, his share will be represented by one and a half. If the produce of land be as ten, and the landlord has one fifth of it, his share will be represented by two. In the latter case, therefore, though the proportion of the landlord's share to the whole produce is greatly diminished, his real rent, independently of nominal price, will be increased in the proportion of from three to four. And in general, in all cases of increasing produce, if the landlord's share of this produce do not diminish in the same proportion, which though it often happens during the currency of leases, rarely or never happens on the renewal of them, the real rents of land must rise."<sup>30</sup>

Alfred Marshall defers the nature of the rent from the nature of the wages. "For we are learning that what is commonly called the rent of land is really a very complex thing made up of many elements, some of which differ more widely from one another than it, as a whole, differs from profits, or than some elements of it differ from wages. And as the obverse of this movement, those elements in rent, in profits, and in wages, which are similar to one another, are being drawn together, and the particular laws which govern them are being subsumed under more general laws common to all."<sup>31</sup>

Schumpeter discusses the issue of 'Rent of Land' and quotes Smith: "Rent is partly an interest payment on investments made by the landlord and partly a payment for the 'natural and indestructible powers of the soil'." He argues with the attitude of

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<sup>30</sup> Malthus, T. R., *ibid.*

<sup>31</sup> Marshall, Alfred. *On Rent*, Economic Journal vol. 3, 1893, Universite Paris 1, CHPE Centre d'Histoire de la Pensée Economique, <http://panoramix.univ-paris1.fr/CHPE/Textes/Marshall/Principles/>



Adam Smith: "A. Smith's theory of value... 'the rent of land... considered as the price paid for the use of land, is naturally a monopoly price' (Wealth, Book I, ch. II). If this were true, rent would have to 'enter into the composition of the price of commodities' exactly as do profit and wages, which A. Smith explicitly denies on the next page. But of course it is not true: the landed interest is not a single seller and therefore its income cannot be explained by the theory of monopoly."<sup>32</sup>

The various attitudes to the nature of rent are described clearly in those words: "The history of economic thought can be divided into three broad approaches as to the theory of land rent -- the surplus over the cost of production on land theory (1662-1776), the marginal productivity theory (1871-1936), and the intersectoral-net product theory (1960)."<sup>33</sup>

## 4.5 The Co-influence between Rent and Taxes

Smith describes the co-influence among the height of the rent and taxes and wrote that taxes upon consumable commodities "necessarily raises their price somewhat higher than the amount of the tax, because the dealer, who advances the tax, must generally get it back with a profit. Such a tax must, therefore, occasion a rise in the wages of labour proportionable to this rise of price. It is thus that a tax upon the necessaries of life operates exactly in the same manner as a direct tax upon the wages of labour... His employer, if he is a manufacturer, will charge upon the price of his goods this rise of wages, together with a profit; so that the final payment of the tax, together with this overcharge, will fall upon the consumer. If his employer is a farmer, the final payment, together with a like overcharge, will fall upon the rent of the landlord."<sup>34</sup>

In the feudal regime, the landlords were imposing upon their tenants' tallage, that

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<sup>32</sup> Schumpeter, Joseph. History of economic analysis, George Allen & Unwin Ltd., sixth printing 1967, p. 264.

<sup>33</sup> Land rent, Etwell, John (ed). The New Palgrave a Dictionary of Economics, volume 3, pp. 118-120, the Macmillan Press Limited, London, 1987.

<sup>34</sup> Smith, Adam. The Wealth of the Nations, book 5, chapter II, article IV - Taxes upon Consumable Commodities, pp.1169-1170, Electric Book company, London, <http://www.elecbook.com/admsmith.zip>

may be considered as a tax or a rent paid for the land they owe.<sup>35</sup>

Thomas Malthus referred to the co-influence among the price of the corn, the height of the rent, and the taxes imposed on the land. "It is a great mistake to suppose that the effects of a fall in the price of corn on cultivation may be fully compensated by a diminution of rents. Rich land which yields a large net rent, may indeed be kept up in its actual state, notwithstanding a fall in the price of its produce: as a diminution of rent may be made entirely to compensate this fall and all the additional expenses that belong to a rich and highly taxed country. But in poor land, the fund of rent will often be found quite insufficient for this purpose. There is a good deal of land in this country of such a quality that the expenses of its cultivation, together with the outgoings of poor rates, tithes and taxes, will not allow the farmer to pay more than a fifth or sixth of the value of the whole produce in the shape of rent."<sup>36</sup>

Henry George,<sup>37</sup> who was a reformer, proposed the "single tax" method: that the state taxes away all economic rent -- the income from the use of the bare land, but not from improvements -- and abolishes all other taxes.

Originally, a tax upon land values proposed as the sole source of government revenues intended to replace all existing taxes. Advocates argued that since land is

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<sup>35</sup> "The great nobility, who had consented that the king should tallage the profits of their own tenants, were not unwilling that he should tallage likewise those of an order of men whom it was much less their interest to protect." *ibid.* p. 1179

<sup>36</sup> Malthus, T. R. The Corn Laws, Observations on the Effects of the Corn Laws, and of a Rise or Fall in the Price of Corn on the Agriculture and General Wealth of the Country, 1814, p.17, Electric Book company, <http://www.elecbook.com/malcorn.zip>

<sup>37</sup> The writer of the book Progress and Poverty. George's book caught the spirit of discontent that had arisen from the great depression of 1873-78. As a basis for his argument, George gave new meaning to the orthodox, or "Ricardian," doctrine of rent. He applied the law of diminishing returns and the concept of "margin of productivity" to land alone. He argued that since economic progress entailed a growing scarcity of land, the idle landowner reaped ever greater returns at the expense of the productive factors of labour and capital. This unearned economic rent, he held, should be taxed away by the state. George envisaged that the government's annual income from this "single tax" would be so large that there would be a surplus for expansion of public works. His economic argument was reinforced and dominated by humanitarian and religious appeal. George Henry, Encyclopaedia Britannica, Britannica.com editors, <http://www.britannica.com/eb/article?eu=37207>

a fixed resource, the economic rent is a product of the growth of the economy and not of individual effort; therefore, society would be justified in recovering it to support the costs of government. They accepted the view of the economist David Ricardo that a tax on economic rent could not be shifted forward. A second argument was that acceptance of the "single tax" would make other forms of taxes unnecessary, and eliminating taxes on buildings would stimulate construction and economic growth. A third advantage cited was the simplicity of administration of a single tax.

Critics found the tax contrary to the usual standard of ability to pay, since there is no correlation between land ownership and total wealth and income. Moreover, portions of other incomes may be considered just as much "unearned" as land rent. Practically, separation of the value of land and the value of buildings would be very difficult.

While no attempt has been made to use the land tax as a single tax, several jurisdictions have applied their property taxes to land only, instead of to land and buildings, or have taxed land more heavily than buildings. Examples include Australia, New Zealand, the western provinces of Canada, and a few municipalities in the United States.<sup>38</sup>

#### **4.6 The Influence of Growing Population on the Profit from Land**

There is a continuous process in value growing of land, and simultaneously the profit of land is growing. These phenomena are unavoidable results of the growing population. More people have to share the same amount of land; therefore, there is less land for each person or family. As the size of land, that can support the dwelling and the livelihood of a family is decreasing, more people dedicate their resources to achieve a smaller size of land. The growth of the population and the modern methods of consuming land enable the continuous process in value growing of land.

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<sup>38</sup> Single tax, *Encyclopaedia Britannica*, Britannica.com editors, <http://www.britannica.com/eb/article?eu=69691>

I prefer the attitude that is brought in Encyclopaedia Britannica: "Land value reflects its relative scarcity, which in a market economy usually depends on the ratio between the area of usable land and the size of that area's population. As the per capita land area declines, the relative value of land rises, and land becomes increasingly a source of conflict among economic and social groups within the community."<sup>39</sup>

Schumpeter wrote about the growing population problem. "The problem of population, that is to say, the questions what it is that determines the size of human societies and what the consequences are that attend the increase in the number of the country's inhabitants, might well be the first to occur to a perfectly detached observer as soon as he looks at those societies in a spirit of scientific curiosity... The analytic complement of the populationist attitude boils down to one proposition: *under prevailing conditions*, increase in heads would increase real income per head. And this proposition was manifestly correct."<sup>40</sup>

Schumpeter quotes Smith about the growing population problem. "A. Smith summed up by reducing the principle of population to a stale truism, preserving however its character as natural law: 'every species of animals naturally multiplies in proportion to the means of their subsistence, and no species can ever multiply beyond it.' (Wealth, Book I, ch. 8.) And at the same time he declared, in the spirit of the old populationists, that 'the most decisive mark of prosperity of any country is the increase of the number of its inhabitants' (ibid.)."<sup>41</sup>

About one hundred and fifty years earlier to Schumpeter, Ricardo stated an optimistic point of view. "Profits might even increase, because the population increasing, at a more rapid rate than capital, wages might fall; and instead of the value of one hundred quarters of wheat being necessary for the circulating capital, ninety only might be required: in which case, the profits of stock would rise from

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<sup>39</sup> Land reform, Introduction, [Encyclopaedia Britannica](http://www.britannica.com/eb/article?eu=109594), Britannica.com editors, <http://www.britannica.com/eb/article?eu=109594>

<sup>40</sup> Schumpeter, Joseph. [History of economic analysis](#), George Allen & Unwin Ltd., sixth printing 1967, pp. 250-252.

<sup>41</sup> Schumpeter, Joseph. *Ibid.*, pp. 257-258.

fifty to fifty-seven per cent."<sup>42</sup>

## 4.7 The Forecast of Malthus on the Population Issue

The Malthus<sup>43</sup> Legacy - Two hundred years ago, Thomas Robert Malthus, a British priest, professor of history and economics with a background in mathematics and theology wrote "An Essay on the Principle of Population" (1798).<sup>44</sup> In this essay, he argued that the world population would increase faster than the food supply, with disastrous results for the general human welfare. The Malthus prophecies have been delayed for nearly two centuries by the advancing technologies and the "Green Revolution" which have dramatically increased food production throughout the world. However, these advances appear to have maximized the food production of a finite world while population continues to grow unrestrained. In the following pages I will present opinions regarding Malthus's anticipated population growth and the effect of food limitations on the living standards of an over populated world.

This essay of Malthus is quoted nowadays by many scholars. Jim Fidler calls it: "The deadly legacy of Thomas Malthus".<sup>45</sup> Henry Hazlitt refers to it in his essay "The Conquest of Poverty".<sup>46</sup> Brown, Gardner and Halweil mention it in the "Dimensions of the Population Problem".<sup>47</sup> Donella H. Meadows writes - "200

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<sup>42</sup> Ricardo, David. An Essay on Profits 1815, On the Influence, &c. London: Printed for John Murray, Albemarle St., McMaster University, Faculty of Social Sciences, <http://socserv2.socsci.mcmaster.ca/~econ/ugcm/3ll3/ricardo/profits.txt>

<sup>43</sup> See Thomas Malthus homepage at <http://www.voyager.co.nz/~malthi/>

<sup>44</sup> Malthus, T. R. An essay on the Principle of Population, The Electric Book company, London, 1997 (First edition 1789), p 122, <http://www.elecbook.com/malpopn.zip>

<sup>45</sup> Fidler, Jim. The deadly legacy of Thomas Malthus, The myth of overpopulation, The Pages Organisation, <http://www.pages.org/bcs/bcs090.html>

<sup>46</sup> Hazlitt, Henry. The Conquest of Poverty, Chapter 2: Poverty and Population, The Henry Hazlitt Foundation, Originally published by Arlington House, 1973 (New Rochelle, NY). Reprinted by University Press of America, 1986 (Lanham, MD) and by The Foundation for Economic Education (Irvington, NY). <http://www.hazlitt.org/e-texts/poverty/ch2.html>

<sup>47</sup> Brown, Lester R., Gardner, Gary., Halweil, Brian. Beyond Malthus: Sixteen Dimensions of the Population Problem, World Watch Institute, Paper 143, <http://www.worldwatch.org/pubs/paper/143.html>

Years Since Malthus and We Still Haven't Proved Him Wrong. This year is the 200<sup>th</sup> anniversary of a small pamphlet that people are still arguing about. In 1798 the Reverend Thomas Robert Malthus said forcefully that the human population tends to grow to the point where it impoverishes itself and starves."<sup>48</sup>

Charles Darwin wrote "In October 1838, that is, fifteen months after I had begun my systematic inquiry, I happened to read for amusement Malthus on *Population*, and being well prepared to appreciate the struggle for existence which everywhere goes on from long- continued observation of the habits of animals and plants, it at once struck me that under these circumstances favorable variations would tend to be preserved, and unfavorable ones to be destroyed. The results of this would be the formation of a new species. Here, then I had at last got a theory by which to work".<sup>49</sup>

Malthus wrote his famous essay on population in order to controvert notions of human perfectibility which were still current in the wake of the French Revolution (1789), and espoused by such writers as William Godwin (1756-1836) and others. Malthus's purpose was to explode such notions based on his view of the inevitable scarcity that would always be a result of human overpopulation.<sup>50</sup>

Peter Landry wrote: "Going against the writings of Godwin and Rousseau Malthus, in his famous work, *An Essay on the Principle of Population*, opined that poverty and distress are unavoidable because population increases faster than the means of subsistence. As checks on population growth, Malthus accepted only war, famine, and disease but later added moral restraint, as well. His theory, at the time of its pronouncement, was most controversial; however, it has not held much currency in the past century, or so; this, because population levels have not come up to the levels expected. The reason, I think, is because of the introduction of inexpensive and readily available birth control procedures; and, of course, because of cultural changes. Malthus, in addition, did not consider the new technology,

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<sup>48</sup> Meadows, Donella H. *The Global Citizen*, the Sustainability Institute, October 8, 1998, <http://iisd1.iisd.ca/pcdf/meadows/malthus.html>

<sup>49</sup> A quotation from Charles. *Darwin Autobiography*, (1876), <http://www.ucmp.berkeley.edu/history/malthus.html>

<sup>50</sup> The International Society of Malthus, <http://www.igc.apc.org/desip/malthus/background.html>

which has increased food production and its distribution. Yet, the world population increases."<sup>51</sup>

Niles Eldredge wrote: "Will Malthus Be Right? His forecast was ahead of its time, but nature may still put a lid on humanity... His 'Essay on the Principle of Population,' published in 1798, predicted a gloomy future for humanity: our population would grow until it reached the limits of our food supply, ensuring that poverty and famine would persistently rear their ugly faces to the world. The most casual cruise on the Internet shows how much debate Malthus still stirs today."<sup>52</sup>

Basically, one may say that Malthus was wrong. The population has continued to grow, economies remain robust - and famines in Biafra and Ethiopia are more aberrations than signs of the future. But one may reply that Malthus was right, but technology has postponed the day of reckoning.

But the most interesting and scholar comment was brought by Schumpeter<sup>53</sup> that refers to the second postulate of the *Essay on the Principle of Population*. "That the Population of the world, or, in other words, the number of persons inhabiting it, is limited only by moral or physical evil, or by fear of a deficiency of those articles of wealth which the habits of the individuals of each class of its inhabitants lead them to require."

Schumpeter objects to Malthus's theory. "We have seen already that all the facts and arguments that Malthus presented in the first edition of his *Essay* (1798), down to details of the analysis as well as of the applications, has been worked out before by so large a number of writers that we may speak of them as widely accepted at the beginning of the nineties." Then he says: "The second edition of the *Essay on the Principle of Population* (1803) is a completely new work, which, beside copious statistics, contains an entirely different theory." Thus - interesting phenomenon - the teaching of Malthus *Essay* became firmly entrenched in the

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<sup>51</sup> Landry, Peter. Thomas Robert Malthus (1766-1834),  
<http://www.blupete.com/Literature/Biographies/Philosophy/Malthus.htm>

<sup>52</sup> Eldredge, Niles. Will Malthus Be Right? Visions of the 21st Century, in Time Magazine,  
[http://www.time.com/time/reports/v21/health/malthus\\_mag.html](http://www.time.com/time/reports/v21/health/malthus_mag.html)

<sup>53</sup> Schumpeter, Joseph. History of economic analysis, George Allen & Unwin Ltd., sixth printing 1967, pp. 578-581.

system of the economic orthodoxy of the time in spite of the fact that it should have been, and in a sense was, recognized as fundamentally untenable or worthless by 1803 and that further reasons for so considering it were speedily forthcoming.

#### **4.8 Dividing the Profit among the Parties**

Profit is the goal of man whether he lives under a feudal regime, a socialistic society, or a capitalistic society. The labourer wants to gain from his work, the loaner expects to gain from his capital, and the landlord hopes to gain from his land. Thus, the philosophical and social issue that was presented in this chapter is the "correct" portion of each party in this total profit.

The different points of view represent the vast economical and social changes that occurred since the industrial revolution. In the 19<sup>th</sup> century, Europe faced a transfer from a feudal slavery to an urban slavery, which became the ground for the socialistic revolution and the communistic regime.

In the 20<sup>th</sup> century, we face the rise of the liberal-capitalistic societies, especially after the 2<sup>nd</sup> World War in Europe and in North America. In those societies the law tries to balance the opposing interests among the labourer, the loaner and the landlord.

Nowadays, the common goal of these three parties is aimed against the heavy taxes imposed by the state and the local municipalities. The landlords are no longer the rulers of the state, and the power to govern is granted to a new social class of "chosen clerks" who's outstanding talent is to come to power and survive as long as possible. This common goal reduces the historical cross-interests among the classical three opponents -- the labourer, the loaner and the landlord.