First Part:
Wages and Capital

Chapter 1:
Why Traditional Theories of Wages are Wrong

FIRST, LET'S CLEARLY DEFINE the problem we are investigating and review how currently accepted theories attempt to explain it. We want to discover why poverty persists despite increasing wealth. It is universally recognized that wages tend toward a minimum level. Whatever causes this must also cause the persistence of poverty. So let's frame our inquiry like this:

Why do wages tend to decrease to subsistence level, even as productive power increases?

Current theory erroneously attempts to explains it thus: (a) wages are set by the ratio between the number of workers and the amount of capital available for labor; (b) population is presumed to increase faster than the increase in capital; (c) therefore, wages always move toward the lowest level workers will tolerate. That is, wages are equal to capital divided by population. Increasing population is held in check only by the limitations of

wages, so even if capital increases toward infinity, there will be no improvement.

In plain English, current theory incorrectly claims that wages cannot rise faster than the population among which capital must be divided. Only low wages will slow the population growth of workers.

This doctrine, though false, is virtually undisputed; it is endorsed by noted economists and taught in great universities. It is popular among those not clever enough to have theories of their own, as may be seen daily in newspaper columns and legislative debates. The general public holds even cruder forms. Why—despite obvious inconsistencies and fallacies—do people cling to protectionist views? They accept the mistaken belief that each community has only a fixed amount of wages available, and that this would be further divided among "foreign competition." This misconception is the basis of most other failed attempts to increase the workers' share, such as restricting competition or abolishing interest.

Yet, despite being so widely held, this theory simply does not fit the facts.

If wages are set by the ratio between labor and capital, then the relative abundance of one must mean a lack of the other. Now, if capital is not used for wages, it can be invested elsewhere. So the current interest rate is a relatively good measure of whether capital is scarce or abundant.

According to this theory, then, high wages (scarce labor) must be accompanied by low interest (abundant capital). In the reverse case, low wages (abundant labor) must be accompanied by high interest (scarce capital).

But we can see that, in fact, the opposite is true: Interest is high when wages are high. Interest is low when wages

are low. Wherever labor goes seeking higher wages, capital also flows seeking higher interest. Whenever there has been a general rise or fall in wages, there has been a similar rise or fall in interest at the same time.

Wages are usually higher in new countries (where capital is relatively scarce) than in old countries (where capital is relatively abundant). Both wages and interest have been higher in the United States than in England, and in the Pacific rather than in the Atlantic States. In California, when wages were higher than anywhere else in the world, interest was also higher. Later, wages and interest in California went down together.

Consider the economics of "good times" and "hard times." A brisk demand for labor (and good wages) is always accompanied by a brisk demand for capital (and high interest rates). However, when jobs are scarce and wages slump, there is always an accumulation of capital seeking investment at low rates.

It is true that rates may be high during commercial panics. However, this is not properly called a high rate of interest. Rather, it is a rate of insurance against risk.

The present depression (1879) has seen unemployment and lower wages. It has also seen the accumulation of unused capital in all the great cities, with nominal interest on safe investments.

These are all well-known facts. They do point to a relationship between wages and interest—but it is a relation of conjunction, not of opposition. There is no explanation of these conditions that is consistent with current theory.

How, then, could such a theory arise? Why was it accepted by economists from Adam Smith to the present? If

we examine the reasoning supporting this theory, it becomes clear that it is not an induction from observed facts. Rather, it is a deduction from a previously assumed theory.

Specifically, it has already been assumed that wages are drawn from capital.

If capital is the source of wages, it logically follows that total wages must be limited by the capital devoted to wages. Hence, the amount individual laborers can receive must be determined by the ratio between their number and the amount of capital available.

This reasoning process is logically valid. However, as we have seen, the conclusion drawn from it does not fit the observed facts. Therefore, the problem must be in the premise.

I am aware that the idea that wages are drawn from capital is one of the most fundamental and widely accepted theorems of current political economy, accepted as axiomatic by all the great economists. Nevertheless, I think I can demonstrate that this is a fundamental error. It forms the basis of a long series of errors that distort the practical conclusions drawn from them.

The proposition I intend to prove is this:

*Wages are not drawn from capital. On the contrary, wages are drawn from the product of the labor for which they are paid.**

Now, while current theory says wages are drawn from capital, it also says capital is reimbursed from production.

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* For simplicity, George restricts his analysis here to the production of physical wealth. Wages for services, the use of labor to satisfy desires directly, are not advanced from capital, but from wealth devoted to consumption (see page 33).

So at first glance this may appear to be a distinction without a difference. If this were merely a change in terminology, any discussion would only add to the meaningless petty arguments that comprise so much of economics. But it will become apparent that this is much more than a formal distinction. Indeed, all the current theories regarding the relation between capital and labor are built on this difference. Doctrines deduced from it are regarded as axiomatic; they limit and direct the ablest minds in discussing issues of momentous importance.

Among the beliefs based on the assumption that wages are drawn directly from capital—not from the product of labor—are the following: industry is limited by capital; labor can only be employed as capital is accumulated; every increase of capital enables additional employment; conversion of circulating capital into fixed capital reduces the fund available to labor; more laborers can be employed at low wages than at high wages; profits are high when wages are low; profits are low when wages are high.

In short, almost all the important theories of current political economy are based on the erroneous assumption that labor is paid out of existing capital before any product is produced. I maintain, on the contrary, that wages are drawn directly from the product of labor. They do not—even temporarily—come close to relying on existing capital.

If I can prove this, then all those other theories are left without any support and must be discarded—including all theories based on the belief that the supply of wages is fixed. For such reasoning holds that as the number of workers increases, the share to each must diminish.

On this foundation, current economists have built a

vast superstructure of related theories. But in truth, this foundation has merely been taken for granted. Not the slightest attempt has been made to distinguish whether or not it is based on fact.

It is inferred that wages are drawn from preexisting capital because wages are generally paid in money. In many cases, wages are paid before the product is fully completed or useful. From this it is concluded that industry is limited by capital. That is, that labor cannot be employed until capital has been accumulated; and then, only to the extent of such capital.

Yet in the same books holding these theories, we find the contradiction. First they claim, without reservation, that capital limits labor. Then they state that capital is stored up or accumulated labor. If we substitute this definition for the word capital, the proposition refutes itself. That is, it says labor cannot be employed until the results of labor have been accumulated. This is patently absurd. But we cannot end the argument with this *reductio ad absurdum* alone, for other explanations are likely to be tried. Perhaps Divine Providence provided the capital that allowed the first labor to begin? More likely, the proposition would be said to refer to more advanced societies where complex production methods are used.

However, there is a fundamental truth in all economic reasoning that we must firmly grasp and never let go of. Modern society, though highly developed, is only an elaboration of the simplest society. Principles that are obvious in simple relationships are not reversed or abolished in more complex ones. The same principles are merely disguised by the use of sophisticated tools and the division of labor.

The modern grist mill, with all its complicated machinery, is only a means of grinding corn. Factory workers may run machines, print labels, or keep books. Yet, they are really devoting their labor to the same task: preparing food. The modern mill serves the same purpose as an ancient stone mortar unearthed by archeologists. Both the ancient and modern workers are attempting to satisfy their desires by exerting labor on natural resources.

Modern economy is a vast and intricate network of production and exchange, with complex operations infinitely subdivided into specialized functions. Yet looking at production as a whole, we see it is the cooperation of all to satisfy the desires of each. Keeping this in mind, we see clearly that the reward each obtains, though engaged in diverse tasks, comes truly and directly from nature as the result of that particular exertion. It is no different from the efforts of the very first human.

Consider the example of a primitive fishing village. Under the simplest conditions, they all catch their own fish and dig their own bait. Soon, they realize the advantage of a division of labor. So now one person digs bait while the others go out fishing. It is obvious at this point that the one who digs bait is, in reality, doing as much toward catching fish as those who actually take in the catch.

Next the advantages of canoes are discovered. Instead of each person building a canoe, only one stays behind to make and repair canoes for the others. In reality, the canoe-maker is devoting labor to catching fish as much as those actually fishing. The fish eaten each night are as much a product of the labor of the canoe-maker as they are of the labor of those fishing. As the division of labor continues, we find that one group fishes, another hunts, a third

picks berries, a fourth gathers fruit, a fifth makes tools, a sixth builds huts, and a seventh prepares clothing.

Division of labor, when fairly established, benefits all by common pursuit. It is used instead of individuals attempting to satisfy all of their wants by directly resorting to nature on their own. As they exchange with each other the product of their labor for the products of others' labor, they are really applying their own labor to the production of the things they use—just as if each person had made each item alone. They are, in effect, satisfying their own particular desires by the exertion of their own individual powers. That is to say, they genuinely produce whatever they receive.

These principles are obvious in simple society. If we follow them through the complexities of what we call civilization, we can clearly see the same principles. In every case where labor is exchanged for commodities, production actually precedes enjoyment. Such wages are not the advance of capital.

Someone's labor has contributed to the general stock of wealth. He receives in return a draft against this general stock. He may use that draft in any particular form that will best satisfy his desires. Though the money itself may have been printed before his labor, it is really an exchange of the products of his labor for the products of others' labor. The important point is that neither the money, nor the particular items he chooses to buy, are advances of capital. On the contrary, money is merely a draft that represents the wealth his labor has already added to the general stock.

Keeping these principles in mind, we can see the same truth in a variety of examples. An engineer cooped up in

some dingy office drawing plans for a great turbine is, in reality, devoting her labor to the production of bread and meat. She is doing so just as truly as if she were harvesting grain in California or swinging a lariat on the pampas of Argentina. She is as truly making her own clothes as if she were shearing sheep in Australia or weaving cloth in a factory. She is effectively producing the wine for her dinner just as though she had gathered the grapes in France.

A miner, digging silver ore thousands of feet underground, is, by virtue of a thousand exchanges, in effect harvesting crops in the valley or fishing in the arctic; picking coffee in Honduras and cutting sugar in Hawaii; gathering cotton from Georgia and weaving it in Manchester; or plucking fruit in the orchards of California.

The wages he receives for the week are merely certificates to show the world that he has done these things. The money he receives in return for his labor is only the first in a long series of exchanges. These transmute his labor into those particular things for which he has really been laboring.

All this is clear when we look at it this way. But the fallacy remains firmly entrenched in many hiding places. To reveal it, we must now change our investigation from the deductive to the inductive. Our conclusions have been obvious when we began with general principles and deduced specific examples. Let us now see if we arrive at the same conclusions inductively—that is, by examining specific facts and tracing their relations into general principles.