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Title: The importance of Political Economy in the education of political and business leaders

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'Give us a guide," cry men to the philosopher. "We would escape from these miseries in which we are entangled. A better state is ever present in our imaginations, and we yearn after it; but all our efforts to realize it are fruitless. We are weary of perpetual failures; tell us by what rule we may attain our desire.'

Witnessing the misery and poverty of mid 19th century Britain, Herbert Spencer, began his *Social Statics* with the above words. He had in mind, perhaps, Plato's *Republic* on the role of the philosopher in educating a political elite - the guardians, as he called them. One of the best known passages from that work is that the human race '*will never have rest from its evils until philosophers are kings, or kings have the spirit and power of philosophy, and political greatness and wisdom meet in one'*.

In view of the present state of the world, I think we can agree that humanity has not yet found 'rest from its evils'. As economists have assumed such a dominant role in policy making, this paper will explore whether there is any particular wisdom to be found in Political Economy that can guide us in lessening the evils currently suffered by humanity.

Political Economy, or Economics as it is now called, was not a distinct discipline at the time of Plato. It only became a special study in the second half of the18th century, first in France under the Économistes, or Physiocrats as they are more commonly called, and then in Britain with Adam Smith, often referred to as the 'father of modern economics'. The circumstances in which it emerged as a distinct subject were similar to the ones we are now facing, a mal-functioning of the economic order, which led thinking men and women to ask whether there might be a better way.

More recently the Great Depression of the 1930s led to the emergence the new brand of Keynesian economics which has come back into fashion as a way of dealing with the present crisis, with many attributing the current turmoil to market failure, but, as will be argued in this paper, it is really a failure of governance. What do I mean by this?

Markets are a natural phenomenon which arise wherever humans meet to trade. They are in the nature of things and cannot be abolished. The ideologically inspired Soviet Union tried in vain to do so. To ensure equal treatment for everyone, the state charged the same rent for all apartments of the same size. This was egalitarian, but ignored the element of location, another natural phenomenon. Thus by subletting, the owner of a favourably located flat could charge a higher rent which reflected its market value, and pocket the difference which could be considerable. Thus, contrary to intention, a property market arose, albeit a black market. *How* markets operate is a matter of governance, something governments can change.

So the starting point in educating a future leaders is to acknowledge that there are natural laws governing economics, which cannot be gainsaid by democratically elected governments or autocratic despots. As Edmund Burke, expressed it:

'The principles that guide us, in public and in private, as they are not of our devising, but moulded into the nature and the essence of things, will endure with the sun and the moon – long, very long after Whig and Tory, Stuart and Brunswick, all such miserable bubbles and playthings of the hour, are vanished from existence and from memory.' (draft of letter to Bishop of Chester, 1771, *Correspondence.*1, pp332-3)

This was appreciated by the classical economists, beginning with Adam Smith's *Inquiry into the Nature and Causes of the Wealth of Nations*, but modern economists have shied away from natural law. There is, however, evidence of some unease about modern economics; for example, a lead article in *The Economist* (23/08/1997) was entitled 'The puzzling failure of economics'. It offered no solution except a general reference to the classical economists. What follows is an attempt to pinpoint where the basic error lies.

A fundamental fact of life, 'moulded into the nature and essence of things', is that all material wealth is the product of three factors which the classical economists called Land, Labour and Capital.

<u>Land</u>

Land is probably associated in most of our minds with the rural countryside, but as an economic term it includes all that Nature provides free to all who inhabit the Earth. Without it no human activity can take place; indeed life as we know it would not be possible. Modern science has expanded the range of nature's free gifts we can draw on, such as the radio spectrum, but for practical purposes Land can be equated with the earth's dry surface, for Man is a land animal – the ship has to return to port and the aeroplane has to land.

<u>Labour</u>

Labour is all human effort, mental or physical. The CEO is as much a labourer as the street sweeper or artist. They bring different skills and aptitudes to the task. The product of Labour on Land is material Wealth. A simple example will illustrate: bananas growing on a tree on a desert island are Land, the free provision of Nature. When a shipwrecked sailor climbs the tree to pick them, they become a product, Wealth, which he may consume to satisfy his hunger or trade with anyone else.

<u>Capital</u>

Capital is Wealth used to produce more Wealth. It is an aid to greater productivity - we can dig with our hands, but our productivity will be greater with the help of a spade or JCB. Note, however, that Capital is a man-made product, whereas Land and Labour are the provision of

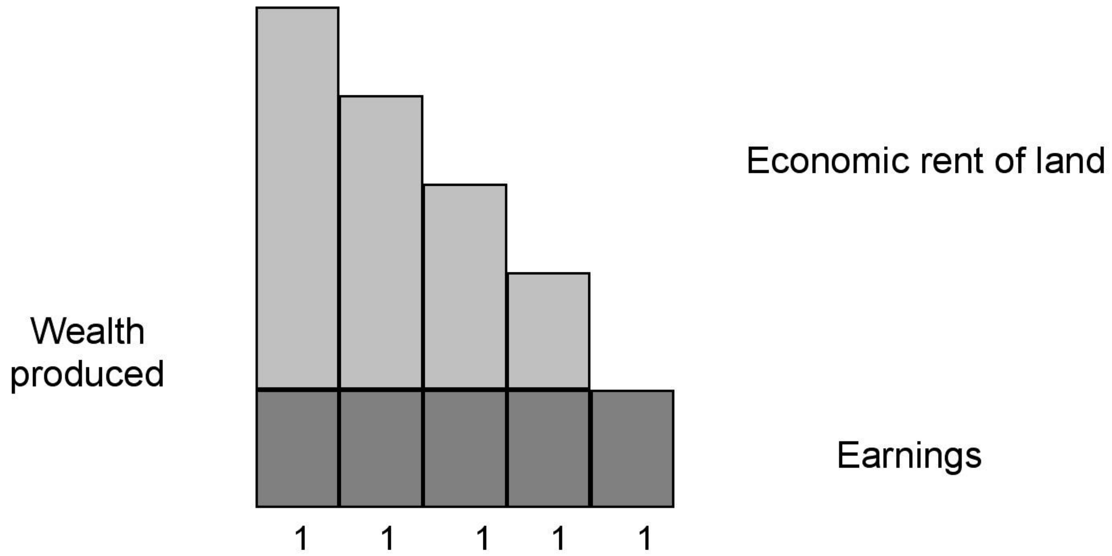
Nature. This fundamental distinction is overlooked by modern economists of both Right and Left. Neo-classical economists treat Land as Capital, an asset like any other used by the entrepreneur, while Marx and the Left regarded Land as an aspect of the means of production. The effect in both cases is that the important distinction between Land, the gift of Nature, and Capital, man-made products, is obscured.

The failure of modern economists to recognise this distinction lies at the heart of the mal-functioning of the global economy. In the above example from the Soviet Union, it is the Land element which gives rise to the variation in rent. In the West, were one to move the Empire State building from Manhattan to the wilds of Alaska, the price of the property would plummet. Estate agents, or realtors, say there are three factors which influence the price of the property: 'location, location, location'. Location is a feature of Land, not of Capital, so to treat Land and Capital as the same, as modern economists do, means the Law of Rent is ignored.

In the Preface to his *Principles of Political Economy, and Taxation*, David Ricardo stressed the importance of this law to the proper understanding of economics:

'…without a knowledge of [the law of rent], it is impossible to understand the effect of the progress of wealth on profits and wages, or to trace satisfactorily the influence of taxation on different classes of the community'

What does he mean by 'the effect of the progress of wealth on profits and wages'? In the context, Ricardo was using the term 'profit' to describe the return to the provider of Capital and 'wages' the return to those who provided Labour. The 'progress of wealth' we would today describe as GDP growth. The diagram below illustrates the relevance of the Law of Rent to growth.



The columns represent the wealth produced on five different sites of equal size and with the same application of Labour and Capital. This reveals how productivity varies despite equal inputs of Capital and Labour because of the different productivity of the five sites. This is another natural law – the productivity of the earth is not homogenous. The variation can be due to natural phenomena, such as soil fertility or the presence of minerals, but more important in a modern economy is location. For example, the takings in a prime retail site on London's Oxford Street will be much greater than those on a village High Street. The reason is footfall – far more people pass the windows of an Oxford Street shop than those of the village shop.

But note, a shop has two elements: the building and the ground on which it stands. In the diagram the paler upper part represents the share of the takings going to the landowner, the ground rent, while the lower the return to the owner of the building who may also charge a rent for the use of the building, but that is a return to Capital. They may be the same person or company, but their entitlement to a share of the product has a different basis.

On the least productive site on the right, the wealth produced is only just sufficient to make the return to Labour and Capital worthwhile. It does not afford any ground rent, but as the marginal site it forms the basis for measuring rent on the more favourable sites - just as altitude is related to sea level. Rent measures the surplus productivity of the more favourable sites.

To revert to Ricardo's point about 'the effect of the progress of wealth on profits and wages', as society expands and develops, more Land will be required. This will mean that Land of an inferior quality (to the right in the diagram) will have to be brought into production. This can be represented by adding a further but shorter column. The effect is to reduce the proportion of the product attributable to Labour and Capital (below the line), while the proportion due to Land increases, or put another way, wages and profits reduce and rents increase as a proportion of the total product. This does not necessarily mean that wages and profits decline in absolute terms, for the benefits of cooperation in a larger society may outweigh the resort to inferior land.

The new site will now become the margin, the horizontal dividing line will move downwards, and the fifth column on the right will now attract rent and the rent on all the other sites will increase. Thus, as the economy expands, rent increases inevitably. The crucial question, as John Kay highlighted in the *Financial Times* (27/11/2009), is who gets the rent?

'You can become wealthy by creating wealth or by appropriating the wealth created by other people. When the appropriation of the wealth is illegal it is called theft or fraud. When it is legal economists call it rent-seeking.'

It requires little imagination to realise that where governments allow the occupiers of the rent-bearing sites to keep the rent, the beneficiaries will enjoy an extra income over and above what they receive as providers of Labour and Capital. The occupier of the prime site could even afford to employ others to work for him and pay them out of the ground rent so that he can enjoy a life of leisure, if he wishes, or he may devote himself to more rent-seeking and grow even richer. Where Land is private property market forces will ensure that the gap between rich and poor widens. Marx pointed out: *'We have seen that the expropriation of the* *mass of the people from the soil forms the basis of the capitalist mode of production'* (*Das Kapital*, Ch. 33). However, land tenure is a matter of governance, not markets

Shocked by the hardship caused by the land enclosures in Britain, Herbert Spencer mounted a powerful, ethical argument against landownership in his 1850 edition of *Social Statics*. His premise is that *'every person has freedom to do all he wills, provided he infringes not the equal freedom of any other person'*. This he called the law of equal freedom which he regarded as the fundamental law to ensure a just society. In his chapter on 'The Right to the Use of the Earth' he begins:

'Given a race of beings having like claims to pursue the objects of their desires; given a world adapted to the gratification of those desires – a world into which such beings are similarly born – and it unavoidably follows that they have equal rights to the use of this world. For if each of them "has freedom to do all that he wills, provided he infringes not the equal freedom of any other", then each of them is free to use the earth for the satisfaction of his wants, provided he allows all others the same liberty. And conversely, it is manifest that no one … may use the earth in such a way as to prevent the rest from similarly using it; seeing that to do this is to assume greater freedom than the rest …' (p.103)

'Equity, therefore, does not permit property in land,' he argues, for if one portion of the earth may be owned then eventually the whole earth may be owned (essentially the state of the world today). He goes on:

'Observe now the dilemma to which this leads. Supposing the entire habitable globe to be so enclosed, it follows that if the landowners have a valid right to its surface, all who are not landowners have no right at all to its surface. Hence, such can exist on the earth by sufferance only. They are all trespassers ... If, then, the assumption that land can be held as property involves that the whole globe may become the private domain of a part of its inhabitants; and if, by consequence, the rest of its inhabitants can then …exist only by the consent of landowners, it is manifest that an exclusive possession of the soil necessitates an infringement of the law of equal freedom. For men who cannot live … without the leave of others cannot be equally free …' (p.104)

So if this is the consequence of permitting private ownership of land, what is the alternative? *'Must we return to the times of unenclosed wilds and subsist on roots, berries and game?'* No, he argues, *'The change required would simply be a change of landlords.'*

'Instead of leasing his acres from an isolated proprietor, the farmer would lease them from the nation … A state of things so ordered would be in perfect harmony with the moral law. Under it all men would be equally landlords; all men would be alike free to become tenants. A, B, C and the rest might compete for a vacant farm as now, and one of them might take that farm, without in any way violating the principles of pure equity. All would be equally free to bid; all equally free to refrain. And when the farm had been let to A, B or C, all parties would have done what they willed – the one in choosing to pay a given sum to his fellow men for the use of certain lands – the others in refusing to pay that sum. Clearly therefore, on such a

system, the earth might be enclosed, occupied and cultivated in entire subordination to the law of equal freedom.' (pp.111-12)

Spencer uses an agricultural example, but the principle is equally relevant to any other kind of property.

In 1879 in America Henry George also recognised that private property in land explained why economic development *under the capitalist system* causes wealth and poverty to increase side by side – hence the title of his book, *Progress and Poverty*, which became a bestseller translated into many languages. As he wrote:

'It is true that wealth has been greatly increased, and that the average of comfort, leisure and refinement has been raised; but the gains are not general. In them the lowest do not share. I do not mean that the condition of the lowest class has nowhere nor in anything been improved; but that nowhere that there is any improvement which can be credited to increased productive power. I mean that the tendency of what we call material progress is in nowise to improve the condition of the lowest class in the essentials of healthy, happy human life. Nay, more, that it is to still further depress the condition of the lowest class. The new forces elevating in their nature though they be, do not act upon the social fabric from underneath, as was for a long time hoped and believed, but strike it at a point intermediate between top and bottom. It is as though an immense wedge were being forced, not underneath society, but through society. Those who are above the point of separation are elevated, but those who are below are crushed down. (p.5-6)

Henry George pointed out that this great injustice could be righted by a simple tax reform, a matter of governance. He argued that taxing Rent (he called it a land-value tax on the basis that land values reflect the rent) rather than Labour and Capital would restore a level playing field represented by the horizontal line in the diagram above. This reform has two great benefits:

1. It restores to all the '*equal rights to the use of this world*', as Spencer described it, ensuring a more equitable distribution of wealth.

2. It provides government with a natural and certain source of revenue without having to tax people's work and wealth - the tax cannot be avoided as Land cannot be moved to tax havens, but equally, what each person earns by his efforts is free of tax.

Acknowledging that private ownership of Land offends against the moral law is as profound a change as the abolition of slavery. The implementation of this reform will require careful handling, but the purpose of this paper is to point out that there is a way to secure a just economic system in accord with the laws of nature – if we wish.