A Principled Approach to Economics

'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 …'

Edmund Burke, draft of letter to Bishop of Chester, 1771, *Correspondence.*1, pp.332-3

Are there principles 'moulded into the nature and the essence of things' to guide us in our search for a 'vision of a new earth'? If so, what are they? How may we distinguish principles from mere theory and opinion?

The Concise Oxford Dictionary offers the following definition of principle: '1) fundamental source, primary element; 2) fundamental truth for basis of reasoning; in Physics etc. general law (e.g. Archimedes' principle)'. A Collins dictionary offers: '1) a moral rule guiding behaviour; 2) general or basic truth'. Edmund Burke's contemporary, Samuel Johnson, in his dictionary defined it simply as 'original cause'.

These definitions support Burke's contention that principles 'are not of our devising', that they are a moral guide and that they are not here today and gone tomorrow. They have a ring of truth.

Today, many would dispute whether there is such a thing as truth. As Professor Allan Bloom pointed out in *The Closing of the American Mind*: 'There is one thing a professor can be absolutely certain of: almost every student entering the university believes, or says he believes, that truth is relative.'[1]

This is the prevalent view in academia and the media, and widely held. We may agree or not, but is it true? We may seek to establish whether my assertion is true by conducting a poll. If the majority agree that truth is relative, then we have established by empirical means that my statement is true, but has it established whether the prevalent view is true or not? Does it matter whether it is true or not, whether the majority are right or not?

If we seek to build a house, we need firm foundations – Jesus drew our attention to the importance of this. The present crisis has demonstrated that the global economy, the economic house we are living in, is built on very shaky ground. Are there any firm foundations on which we can build a new economics? Are there any principles in economics as easy for us to validate as Archimedes' principle is?

I raise this point because, as Paul Ormerod points out in *The Death of Economics*, economists 'have erected around the discipline a barrier of jargon and mathematics which makes the

[1] Allan Bloom, *The Closing of the American Mind*, Simon & Schuster, New York 1987, p.25

subject difficult to penetrate for the uninitiated'.[2] Yet, as Leon MacLaren pointed out: 'A knowledge of economics is essential to good government', and in a democracy 'a general knowledge of economics is essential for good government. A voter who votes in ignorance forges the chains which bind him.'[3] Can we afford to leave economics to the experts?

Are there, then, any self-evident principles of economics with which we can arm ourselves to play a responsible part in ensuring good government?

Let us begin with a few simple questions: Do we not need *somewhere* to live, *somewhere* to work? That somewhere is essentially the earth's dry surface – we can live for a time at sea, but sooner or later we would need to return to land for repairs and restocking. We are all land animals. Land is our natural habitat.

We are all born into this world with needs and desires. Do we not all need food to nourish us, clothing to keep us warm, and shelter against the elements?

Do we not have to work to satisfy those needs and desires? Do we not have to harvest our food, to make our clothes and build a shelter? Nature has provided us with the wherewithall, but we have to work to shape Nature's provision to meet our needs. This is work.

So the two fundamental elements of economics are Land and Work. Is this not as self-evident as Archimedes' principle?

If we only had our hands as tools, would not our lives be almost animal-like? But with tools, from the first sharpened flint stone to the modern production line, we can meet our basic needs more easily, allowing us time for other pursuits to enrich our lives.

However, before we can build a production line, another important element in economics is necessary: co-operation which allows for specialisation and the development of skills. With specialisation comes exchange or trade, the market.

Here then are the basic elements for an inquiry into the nature and causes of the wealth of nations, the full title of Adam Smith's famous book better known as *The Wealth of Nations*. Generally acknowledged as the father of economics, he described how wealth is produced by the combination of three factors: Land, Labour and Capital, the latter being the product of previous work used to facilitate current production, essentially tools.

The emphasis in Adam Smith's inquiry was on the creation of wealth. Forty years later, David Ricardo published his book. He confirms the centrality of the three factors of production in the opening sentence of his preface:

'The produce of the earth – all that is derived from its surface by the united application of labour, machinery, and capital, is divided among three classes of the community; namely the

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[2] Paul Ormerod, *The Death of Economics*, Faber & Faber, London, 1984, p.ix

[3] Leon Maclaren, *The Function of Economics*, School of Economic Science, London, 1997, p.3

proprietor of the land, the owner of the stock or capital necessary for its cultivation, and the labourers by whose industry it is cultivated.'

Ricardo, however, attached more importance to how wealth is distributed, noting that

'in different stages of society, the proportion of the whole produce of the earth which will be allotted to each of these classes, under the names of rent, profit, and wages, will be essentially different … To determine the laws which regulate this distribution, is the principal problem in Political Economy.'[4]

As in his day, we live in a world sharply divided by extremes of wealth and poverty. To Ricardo, the key law which regulated the distribution of wealth was the Law of Rent, sometimes called Ricardo's Law in his honour. He argued that without an understanding of it, *'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'*.

So what does the Law of Rent reveal about the 'progress of wealth on profits and wages'? It illustrates a natural phenomenon, namely that not all land is equally productive. As society and the economy grow, resort will be had to land of lesser quality. Productivity, as we can verify for ourselves, varies for a number of reasons:

1. Natural causes such as soil fertility and climate, richness of mineral deposits,
2. Provision of public infrastructure and services
3. Proximity to markets

The first thing the Law of Rent reveals is that the level of wages and profit in society are determined by the product on the least productive site in use, called the margin of productivity or the marginal site. The product at the margin is only just enough, after paying all bought-in costs, to make it worthwhile to employ labour and capital on that site.

Secondly the law measures the advantage enjoyed by the better sites relative to the marginal site, rather as altitude is measured by reference to sea-level. At the margin there is no rent only enough wealth produced to reward labour with wages and capital with profit. Rent is a surplus which arises only on more productive sites and is the return to the landowner as rent - were all land equally productive, there would be no rent, but this is not the case.

To illustrate the significance of this, take two shops: one in a village street will not sell as much in a day as one in London's Oxford Street. The reason, estate agents tell us, is footfall. However, hard the village shopkeeper may work, however well equipped the shop might be, the takings will be a tiny fraction of that in Oxford Street. The difference in productiveness has nothing to do with the effort put in or the capital invested, but everything to do with location. This is another self-evident fact.

[4] David Ricardo, *The Principles of Political Economy, and Taxation*, 1817

This relative advantage is reflected in the property market as the capital value or annual rental of each site. The question then arises: Who or what creates location value?

To answer that question, it is important to appreciate that we are here talking of the site only, nature's provision, not any improvements made by the occupant, such as buildings. Our example illustrates it is not the shopkeeper who creates that value but it is a property of the site itself. So if site value is not produced by the occupant, to whom does it belong?

Today we say it belongs to the landowner, but if he did not make the land or create its market value, is this right? Does not rent become unearned income if society permits the landowner to pocket what he has not produced?

Before answering that, let's return to Ricardo. He also pointed out that without an understanding of the Law of Rent 'the influence of taxation on different classes of the community' would not be appreciated. What did he mean?

If wages and/or profits are taxed, this will make the marginal site unviable (by definition it is only able to pay wages and profits), thus reducing economic activity, the wealth of nations. However, if taxes were levied on rent, this would not affect the margin as there is no rent to tax. Adam Smith recognised this:

'Both ground-rents and the ordinary rent of land are a species of revenue which the owner, in many cases, enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the state, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth of the great body of the people, might be the same after such a tax as before. Ground rents and the ordinary rent of land are, therefore, perhaps, the species of revenue which can best bear to have a peculiar tax upon them.'[5]

It was an American economist, Henry George,[6] who showed how important an understanding of the Law of Rent is. Seeking an answer to why it is (to this day) that, as a nation's economy develops, the gulf between rich and poor increases, he realised that the key to resolving the issue lies in who gets the rent. He also saw that the remedy lay in taxing land values (the rent) and abolishing taxes on wages and profits.

The efficacy of the remedy was demonstrated after the Chinese Nationalist government fled to Taiwan in 1949. They introduced a land and tax reform and, according to the US Overseas Development Council Chairman, the income gap narrowed by 50% in twelve years (1950-1972).[7]

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[5] Adam Smith, *The Wealth of Nations,* Book V, Ch II, Part II, Article I 'Taxes upon Rent'

[6] Henry George, *Progress and Poverty*, 1879, reprinted by Robert Schalkenbach Foundation, 19

[7] K.T.Li, *Economic Transformation of Taiwan*, Shepheard-Walwyn, 1988, p.56

If we understand the Law of Rent, it becomes apparent we need not interfere with existing land tenure arrangements. We simply need to change the incidence of taxation and this can be done over time to enable society to adjust to the new circumstances.

Henry George's *Progress and Poverty* is dedicated:

'To those who, seeing the vice and misery which spring from the unequal distribution of wealth and privilege, feel the possibility of a higher social state, and would strive for its attainment