The Division of Labor and the Concept of Productive Activity

A. The Doctrine That Only Manual Labor Is Productive

1. Manifestations: the IRS and "earned" vs. "unearned" income; the attitude of labor unions and their supporters; the attitude of socialist governments.

2. Will show that this doctrine rests on ignorance of the requirements of a division-of-labor society, and is both far too narrow and, in one major respect, too broad in its view of what is productive activity.

B. Money Making and Productive Activity

1. Need for money making for activity to be productive in context of a division-of-labor society—need to be able to obtain *products of others* as a result of one's labor. Must earn money to do so. Even manual labor not productive if doesn't earn money. In context of a division-of-labor society, *economic activity is activity the purpose of which is the earning of money.*

Application: the maid who works for money and the housewife who cleans the house without earning money—the significant difference.

2. If activity is not for purpose of making money, it is inherently *consumption*—in that it starts with materials and equipment, which can't be replaced. Physical production, when purpose is not money making, is a *consumptive production.*

3. Productive expenditure and consumption expenditure: expenditure for the purpose of bringing in subsequent sales receipts (implicitly at a profit) versus expenditure *not* for the purpose of bringing in subsequent sales receipts.

Practical significance of distinction: the one is self-sustaining and a source of wealth; the other is a using up of wealth. The case of the two brothers starting with an equal inheritance, one growing richer through productive expenditure, the other growing poorer through consumption expenditure.

4. Capital goods and consumers' goods; producers' labor and consumers' labor; producers' loans and consumers' loans. Purpose for which funds expended or advanced critical, not physical nature of the activity. Heavy machinery can be consumers' goods; all food and clothing are capital goods when bought for business purposes.

a. Consumers' goods that reduce expenses are still consumers' goods—a smaller consumption expenditure is still a consumption expenditure.
b. The status of government borrowing.

5. Adam Smith correctly understood these issues, even though he introduced a second, irrelevant criterion for distinguishing between productive and unproductive activity—namely, the question of whether or not there is a tangible, physical product. But Adam Smith very bad on the questions of the legitimacy of profits and interest and on the productive role of businessmen and capitalists, as we will see, below, under "D."

C. The Division of Labor and Productive Functions

1. The specific productive function of businessmen and capitalists: *to raise the productivity and remuneration of manual labor by creating, coordinating, and improving the efficiency of the division of labor.*

a. Create division of labor: found and organize business firms—the units of the division of labor; provide capital, without which little or no vertical division of labor (and which creates and raises the wage share of consumption).

b. Coordinate the division of labor: internal management, balance among the different branches of industry (uniformity-of-profit principle).
c. Improve efficiency of the division of labor: introduce improved products and methods of production; achieve a sufficient relative production of capital goods to achieve economic progress.

2. The productive function of financial markets and institutions and of passive capitalists: promote saving, investment out of saving, and the efficiency of investment.

a. Promote saving by providing opportunity to earn a rate of return.
b. Investment the same way.
c. Promote efficiency of investment by making it possible to provide use of one's saving to others who can use them more efficiently—e.g., small businessman and the electric utility.
d. Contributes to height of relative production of capital goods and thus to economic progress. (Note: productive role here only in context of division of labor economy and role of capital in production).
e. If the payment of interest and dividends to passive capitalists an exploitation, then at the expense of businessmen, not the wage earners. Implication of the widows and orphans exploiting Rockefeller. But not an exploitation—all gain. Also, investors usually need to perform some labor if no government bonds or government deposit insurance. Else make minimal rate of return—safety and trustee fees.

3. The specific productive function of the stock market in view of the criticism that only the purchase of newly issued stock actually provides funds to business firms.

a. Ability to sell shares encourages buying them in the first place.
b. Holders of outstanding stock can use the funds from its sale for new business purposes—e.g., the small businessman who sells his shares of GM or IBM to obtain money to expand his store.
c. Price of stock sets terms for sale of new shares.
d. Stock market gives more power to stockholders—individually, can sell if investment bad or need the money; low stock price resulting from bad treatment of small stockholders by management makes corporate takeover more likely; compels the management to consider the interests of the small stockholders; also, low stock price makes new financing less favorable.

4. The productive function of retailing and wholesaling:

a. Need distribution system because of division of labor—the products originate in great concentrations, must be brought to all. This the basis of the need for retailing and wholesaling.
b. These institutions lower distribution costs and achieve greater variety available to consumers.

The problem of assembling the ingredients of breakfast.

The case of the 100 manufacturers and the 1000 retailers.

5. Advertising—need information because of division of labor: the sellers and buyers separate parties.

a. More benefit from the same production—toothpaste brand A and brand B; a gain even if costs higher. But extra cost always limited.
b. More research and development—faster acceptance of new products; consequent encouragement of research and development.
c. Promotes competition—new entrants need it to gain exposure. Going by experience alone favors the existing suppliers.
d. Works like a bond posted with public: only pays to advertize good products.

D. The Framework of the Marxian Exploitation Theory: A Critique

1. The Smith-Marx framework.

a. See Smith, *Wealth of Nations,* p. 72, para 1 & 2 of University of Chicago Press Edition; then pp. 73-74 (quoted in *Capitalism*, pp. 476 and 477).
b. Claims labor the source of all wealth; has right to the full produce or to full value of the produce. Claims income of labor is wages; profits, interest, etc. an unjust deduction that arises with the coming of capitalism and capitalists.
c. Marx: C-M-C—equivalent to Smith's early and rude state. Allegedly no "surplus value" here; surplus value only under "capitalistic circulation"—M-C-M′.

2. Under C-M-C—the early and rude state—all income is *profits*, not wages. Demand for commodities is not demand for labor—product sales revenues but zero costs of production because no M laid out to bring in M′.

3. Capitalists don't deduct profits from wages; they create productive expenditure, wages, and costs, which *reduces the profit share* and raises the wage share.

4. Producers in the pre-capitalist economy were profit earners, and the fundamental producers are now, too. The standard of the guiding and directing intelligence. Columbus and his crew. The President and the State Department employees. Ford and Rockefeller.

5. The problem of profits as a labor income and the variation of profits with the amount of capital invested. Adam Smith's denial of profits as a labor income (quoted in *Capitalism* on p. 476). Variation of profit with capital not a contradiction of their attribution to labor of businessmen—the capital is the means by which businessmen implement their ideas. Variation of results with the means employed does not contradict attribution to the intelligence which guides and directs the means.

6. Basis of the critique in classical economics itself.

a. Ricardo's proposition that "profits rise as wages fall and fall as wages rise"—capitalists, not consumers, pay the wages

b. John Stuart Mill's proposition that "demand for commodities is not demand for labor"

A Problem to Test Your Understanding

As explained, Adam Smith and Karl Marx postulated a simple state of affairs in which manual laborers produced and sold products, kept the whole sales proceeds, and did not act as capitalists, i.e., did not buy for the sake of subsequently selling. They believed that in such circumstances all income was wages and no income was profits. They held that profits came into existence only with the development of "capitalistic circulation" (i.e., buying for the sake of selling) and were a deduction from what was originally all wages. To determine what the effect on the rate of profit would be if there were no capitalists, but just sellers of products, you are given the following information, which will test their propositions in the light of the net consumption theory: Receipts from the sale of products are 1000, all of which is consumed by the sellers and constitutes a fresh 1000 of receipts from the sale of products in the next period. Using Chapater 11, Part C, Section 2 as your framework of analysis,

1. State the amount of productive expenditure present.

2. State the amount of wages paid in the production of products.

3. State the amount of money outlays to be deducted from sales revenues as costs.

4. State the amount of profits earned on the sales revenues.

5. State the amount of nominal capital in existence.

6. State the rate of return on capital.

E. Marx's Exploitation Theory of Profits (Surplus Value)—his attempt to explain the extent of the alleged—unjust—deduction of profits et al. from wages.

1. The absolutist labor theory of value—exchange value of everything allegedly determined by congealed labor content and nothing else.
2. Implies all value added is proportionate to fresh labor added, since materials and machinery convey their labor content to the product—neither more nor less.
Thus fresh labor allegedly adds all value—the sum of profits and wages.

Corresponding Marxian terminology of "constant" and "variable" capital.

3. Wages, the value of labor, allegedly determined by quantity of labor required to "produce" labor—i.e., subsistence. Wages put there by the arbitrary power of the capitalists—the Marxian "iron law of wages." Subtraction of wage share of value added by labor, then leaves profit—"surplus value.".
4. Example and elaboration of Marx's theory:

a. 48 hours of labor in materials and machinery + 12 hours of fresh labor yield product embodying 60 hours of labor.

b. If $1 of product value represents every hour of embodied labor, then the materials and machinery that pass into the product are worth $48, while the product itself, embodying 60 hours of labor, is worth $60. The 12 hours of fresh labor adds the whole difference in value between the product and the materials and machinery. This value difference is the sum of wages and profits together.

c. The division of the value added, between wages and profits, says Marx, is determined by the fact that the 12 hours of fresh labor can be purchased at a price representing the number of hours of labor required to "produce" that 12 hours. If, to use Marx's own example, the worker can work for 12 hours on the basis of necessities which require only 6 hours to produce, then, says Marx, he is paid a wage of only $6. Thus the capitalist acquires 12 labor hours and the value added by 12 hours at a price corresponding to only 6 hours.

d. Thus profits are made, says Marx, by the systematic underpayment of labor: the capitalist buys a full labor day, but pays only for the hours required to produce the worker's necessities. The hours the worker works over and above what are required to produce his necessities represent unpaid, "surplus labor time." Profits relative to wages, "surplus value" relative to "variable capital" are both expressions for "the rate of exploitation.".

e. Marx's formula for the rate of exploitation:

Rate of Exploitation = profits/wages = s/v (surplus value/variable capital) = surplus labor time/necessary labor time.

5. The exploitation theory and the Marxian rhetoric: "wage slavery" and the capitalists as the heirs to the slave owners and feudal aristocracy—meant literally. Capitalists depicted as profiting on the same basis as slave owners—the capacity of the workers to produce more than is needed for their own subsistence.

6. Implications of the exploitation theory:

a. All progress passes the workers by—improvements are either in things still beyond their reach, or, if within their reach, their wages are cut correspondingly. Thus, the workers men without a country, with nothing to lose but their chains.

b. Things are still worse: the doctrine of progressive impoverishment: the capitalists more calculatingly greedy than earlier exploiters and the falling rate of profit leads them to constantly increase the rate of exploitation in an effort to offset it. (The falling rate of profit inferred by Marx from a growing proportion of capital in the form of "constant" capital, which adds no value. Thus the surplus value added by fresh labor has to be spread thinner, with the result that the rate of profit falls unless the rate of exploitation is increased. Example: Total capital invested in whole economy initially equals 100 = 50v + 50c. Rate of exploitation is initially 100%. Then s = 50. Rate of profit = 50s/(50v + 50c) = 50%. Now total capital grows to 200, and all the growth is in constant capital. Thus, now, rate of profit = 50s/(50v + 150c) = 25%. Capitalists need to step up the rate of exploitation to offset the fall in the rate of profit.

c. The working day and child labor—step up the rate of exploitation by squeezing more labor out the workers for the same subsistence.

d. Sweat the worker—reduce the labor time needed to produce necessities.

7. Influence of the exploitation theory.

a. Assumed correct by almost everyone as a description of *laissez-faire* capitalism; believed not descriptive of present-day world because of government intervention.

b. The corresponding interpretation of modern economic history—things bad in the past because of the unrestrained greed of the capitalists; better now because of government intervention.

c. The whole "liberal" program a reflection of the influence of the exploitation theory: laws to limit working day—only the capitalists lose; abolition of child labor—only the capitalists lose; boost pay above subsistence through unions and minimum wage laws—again, only the capitalists lose; the welfare state—progressive income and inheritance taxes, on the one side, plus social welfare spending, such as for public housing, public education, social security, socialized medicine, etc., on the other—this seen as simply taking back some of the loot from the exploiters and returning it to the victims.

F. The Productivity Theory of Wages

1. Plausibility of exploitation theory based on ideas of worker need and employer greed—both irrelevant: the cases of the used car and the art auction.

2. Labor useful & scarce—money wage rates fall no lower than corresponds to full employment point (occupation by occupation, place by place). Then the scarcity of labor is felt.

3. Such a drop in wage rates (to the full employment point) doesn't mean subsistence by the back door—the elimination of unemployment that the fall in wage rates brings about means more production and a fall in costs of production. Both mean lower prices. Real wages actually rise with the elimination of unemployment: not only lower prices corresponding to the lower wages, but also the elimination of the burden of supporting the unemployed—thus take home pay drops less than prices.

4. Real wages depend on the productivity of labor—the output per worker. Demonstration of how productivity works:

$$\text{Average money wage rate} = \frac{\textit{Demand}\text{ for }\textit{Labor}\ (D_L)}{\textit{Supply of Labor Employed}\ (S_L)}$$

$$\text{General consumer price level} = \frac{\textit{Demand}\text{ for }\textit{Consumers' Goods}\ (D_C)}{\textit{Supply of Consumers' Goods Sold}\ (S_C)}$$

a. Money supply (and thus monetary demands for labor and goods) constant, population constant, productivity of labor rising.
b. Money supply and thus monetary demands rising, population and productivity constant.
c. Money supply and productivity rising, population constant.
d. Money supply and productivity constant, population rising.
e. Money supply constant, productivity and population rising.
f. Money supply, productivity, and population rising.

5. An algebraic demonstration of the role of productivity in determining real wage rates:

Where
W = the average money wage rate
P = the general consumer price level
D_L = the aggregate demand for labor (total business payrolls)
D_C = the aggregate demand for consumers' goods (total expenditure to buy consumers' goods)
S_L = the supply of labor employed
S_C = the supply of consumers' goods sold
then

1. The average real wage (what the worker's money wages actually buy) = $\frac{W}{P}$

2. W = $\frac{D_L}{S_L}$

3. P = $\frac{D_C}{S_C}$

By substituting equations 2 and 3 into equation 1, we obtain

4. The average real wage = $\frac{D_L}{S_L} \div \frac{D_C}{S_C}$

By following the rule of inverting and then multiplying with the second fraction, we obtain

5. $\frac{D_L}{S_L} \times \frac{S_C}{D_C}$

Finally, by changing the order of multiplication, we obtain

6. $\frac{D_L}{D_C} \times \frac{S_C}{S_L}$

The supply of consumers' goods relative to the supply of labor reflects the productivity of labor. The demand for labor relative to the demand for consumers' goods can be called the "distribution" factor. It represents the extent to which wage payments are the source of consumption expenditure versus other sources of consumption expenditure, such as dividends.

6. Real wages and the economic degree of capitalism—$\frac{M}{M}{}'$: the higher is $\frac{M}{M}{}'$, the higher is $\frac{D_L}{D_C}$ and the higher is $\frac{D_K}{D_C}$. Thus the higher is the wage share of consumption and the more rapidly rising the productivity of labor (because of the higher capital goods share of total output).

a. The increase in the supply of capital goods and the rise in the productivity of labor also depends on the efficiency of the economic system—the productivity of capital goods. The higher the productivity of capital goods, the lower is the maintenance proportion and thus the more rapid the accumulation of capital for any given higher relative production of capital goods.
b. Both the wage share, the relative production of capital goods, and the productivity of capital goods depend on the security of property and economic freedom.

7. The futility of anything but a rise in the productivity of labor as a cause of higher real wages.

a. Increases in the quantity of money.
b. Less population.
c. D_L up at the expense of D_K.
d. Less consumption on the part of non-wage earners. Limited one-shot rise in real wages, but can't obtain by force—same issue as in redistribution discussion. (Capitalists quit if no ability to consume. Can only get higher wage share by voluntary inducement to save more, which requires security of property.) Cut in government spending and taxes increasing the demand for labor more potent, but also of a one-shot nature. Rise in productivity the only source capable of large, continuing increase.

8. The productivity theory of wages explains why the standard of living was so low in the past, including long hours, child labor, and bad working conditions.

9. It explains how all these things improved—the higher productivity of labor based on *respect for private property rights and economic freedom*, which led to higher saving and a higher productivity of capital goods, thus to capital accumulation and a rising productivity of labor; also to higher wage share of consumption. All in degree of respect for private property rights.

a. Hours shortened and child labor eliminated by virtue of rising real wages based on higher productivity of labor—people could then *afford* to work less and keep their children at home longer. How the desire for shorter hours then made it profitable for employers to offer shorter hours.
b. Improvements in conditions achieved in the same way—more of them pay for themselves or workers are able to bear the cost of more of those that can't pay for themselves, because now they have higher real earnings.

10. Uselessness and harm of redistribution: almost nothing to redistribute; attempt to seize it cuts production: less saving, incentives, and capital accumulation, lower $\frac{D_L}{D_C}$—chaos of socialism.

11. The harm of maximum hours and child labor legislation and of forced improvements in conditions (the kind that don't pay for themselves).

a. Forced reduction in amount of labor—e.g., $\frac{D_L}{\frac{3}{4}S_L}$ results in $\frac{3}{4}S_C$ and thus in $\frac{4}{3}P$ (because $\frac{D_C}{\frac{3}{4}S_C} = \frac{4}{3}P$).

Even if weekly or family money income the same, a loss in real terms. If workers work less, get less.
b. Forced improvements in conditions equivalent to forced wage increase: unemployment, higher prices; workers who keep jobs lose, because while prices go up, their take home pay the same; if unemployment to be avoided, the take home wages must drop to offset the cost of the improvements. Either way, they are at the expense of the workers, who can't afford them.

12. Labor unions.

a. Artificial wage inequalities if unions limited in ability to raise wages.
b. Unemployment if raise wage rates through whole system.
c. Lower productivity of labor because of unions' opposition to labor saving machinery and worker competition, and because of featherbedding practices and misallocation of labor.
d. The unions' wrong idea of how to raise the standard of living—they seek to raise money wages, when actually the standard of living rises only through improvements in the productivity of labor, which they fight. Money wages, free competition of individuals and the fallacy of composition.

13. Effects of minimum wage laws: unemployment, lower skill and lower pay long-term, because the unemployed workers don't gain experience. Preventing the less skilled from competing with the more skilled.