



Classical Economics Versus The Exploitation Theory

By George Reisman



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George Reisman, Ph.D., is Professor of Economics at Pepperdine University's Graziadio School of Business and Management in Los Angeles. His web site is www.capitalism.net. His book is available through [Mises.org](#), [Amazon.com](#), and [on his web site](#). You can contact him by [MAIL](#). See his Mises.org [Daily Articles Archive](#), read his interview in the [Austrian Economics Newsletter](#), and post comments on the [blog](#). Copyright © 2005, 1985 by George Reisman. All rights reserved. Permission is granted to post this essay on the internet provided that credit is given to the author and he is notified.

For more than a century, one of the most popular economic doctrines in the world has been the exploitation theory. According to this theory, capitalism is a system of virtual slavery, serving the narrow interests of a comparative handful of businessmen and capitalists, who, driven by insatiable greed and power lust, exist as parasites upon the labor of the masses. This view of capitalism has not been the least bit shaken by the steady rise in the average standard of living that has taken place in the capitalist countries since the beginning of the Industrial Revolution. The rise in the standard of living is not attributed to capitalism, but precisely to the *infringements* which have been made upon capitalism. People attribute economic progress to labor unions and social legislation, and to what they consider to be improved personal ethics on the part of employers. By the same token, they tremble at the thought of unions not existing, of a society without minimum wage laws, maximum hours legislation, and child labor laws—at the thought of a society in which no legal obstacles stood in the way of employers pursuing their self-interest. In the absence of such legislation, people believe, wage rates would return to the minimum subsistence level; women and children would labor once more in the mines; and the hours of work would be as long and as hard as it is possible for human beings to bear—all for the benefit of the capitalists, precisely as Marx maintained.

The Exploitation Theory and the Overthrow of Classical Economics

It is obvious that the exploitation theory is one of the most powerful factors that have been operating to lead the world down *The Road to Serfdom*—as the title of Prof. Hayek's book so aptly describes the trend toward socialism.¹ Indeed, the pernicious influence of the exploitation theory goes far beyond the direct and obvious support it gives to socialism. It has contributed to the triumph of socialism in more subtle ways, as well. It played a major, perhaps the decisive, role in the overthrow of British classical economics. The system of Smith and Ricardo was perceived as inescapably implying the essential tenets of the exploitation theory. The opponents of the exploitation theory, therefore, quite understandably felt obliged to discard such a perverse system. And discard it they did.

Along with “the labor theory of value” and the “iron law of wages,” they discarded such further features of classical political economy as the wages fund doctrine and its corollary that savings and capital are the source of almost all spending in the economic system. Two generations later, the abandonment of the classical doctrines on saving made possible the acceptance of Keynesianism and the policy of inflation, deficits, and ever expanding government spending. In similarly paradoxical fashion, the abandonment of the classical doctrine that cost of production, rather than supply and demand, is the direct (if not the ultimate) determinant of the prices of most manufactured or processed goods led, with just about the same time lag, to the promulgation of the doctrines of “pure and perfect competition,” “oligopoly,” “monopolistic competition,” and “administered prices,” with their implicit call for a policy of radical antitrust or outright nationalizations

¹ F. A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).

to “curb the abuses of big business.” Thus, along these two further paths, the influence of the exploitation theory has served to advance the cause of socialism.

Indeed, so successful has the exploitation theory been in the discrediting of classical economics, that even to suggest that cost of production can be a direct determinant of price is to invite the censure both of being ignorant of all that economics has taught since 1870 and of being sympathetic to Marxism. Thus, it is important to point out in this connection that Böhm-Bawerk and Wieser were well aware of the fact that cost of production is often the direct determinant of price. They held merely that the determination of the prices that constitute the costs is based on supply and demand (a position very close to that of John Stuart Mill, incidentally) and thus on the operation of the principle of diminishing marginal utility.² Most of the followers of Böhm-Bawerk and Wieser seem, unfortunately, to be more influenced by Jevons on this subject than by Böhm-Bawerk and Wieser.³

My purpose here is to show how classical economics can easily cast off those aspects of it which in the past did contribute to the exploitation theory. And, more, to show how it can actually supply the basis for a fundamental and radical *critique* of the exploitation theory. If my effort is judged successful, then perhaps some interest can be reawakened in classical economics as an important source of knowledge, in particular in regard to the critique of Keynesianism and the currently dominant views on monopoly and competition. (The precise nature of these applications is a subject far too vast to be dealt with on this occasion. I have, however, attempted to explain it elsewhere.⁴)

² Cf. Eugen von Böhm-Bawerk, *Capital and Interest*, Huncke and Sennholz translation, 3 volumes (South Holland Illinois: Libertarian Press, 1959), Vol. II, pp. 168-76, pp. 248-56; Vol. III, pp. 97-115; idem, “Wert, Kosten und Grenznutzen,” *Jahrbuch für Nationalökonomie und Statistik*, Dritte Folge, Vol. III, 1892, p. 328 [this essay has subsequently been translated by the present author as “[Value, Cost, and Marginal Utility](#),” *Quarterly Journal of Austrian Economics*, vol. 5, n. 3; see also, idem, my “[Notes on the Translation](#)”]; Friedrich von Wieser. *Ursprung und Hauptgesetze des Wirtschaftlichen Werthes*, Vienna, 1884, pp. 146-160; idem, *Natural Value*, London and New York, 1893, p. 78, p. 181n, p.183; John Stuart Mill, *Principles of Political Economy*, Ashley Edition (reprint, Fairfield, New Jersey: Augustus M. Kelley, 1976), Bk. III, Chaps. III - VI. See also, Reisman, *Capitalism*, pp. 200-201, 206-209, 414-416. (Please note: page numbers in the online, pdf edition of *Capitalism* add 58 pages of front matter.)

³ Jevons held that the only possible connection between cost of production and price was through the intermediary of variations in supply. Cf. W. S. Jevons, *The Theory of Political Economy*, Fourth Edition, (London: Macmillan and Co., 1924), p. 165.

⁴ Chapters, 15 and 18 of my book *Capitalism* deal exhaustively with Keynesianism and its foundations, while Chapter 10 does likewise with the currently prevailing views on monopoly and competition; on this last, see also my “Platonic Competition,” *The Objectivist*, August and September, 1968 (reprint, Laguna Hills, California: The Jefferson School of Philosophy, Economics, and Psychology).

The Conceptual Framework of the Exploitation Theory

There are three aspects of classical economics which contribute to the exploitation theory. The two best known are, of course, the labor theory of value and the iron law of wages. Somewhat less prominent, but no less important, is the conceptual framework within which the exploitation theory is advanced. This framework is *the belief that wages are the original and primary form of income, from which profits and all other non-wage incomes emerge as a deduction with the coming of capitalism and businessmen and capitalists*. The framework easily leads to the assertion of the wage earner's right to the whole produce or to its full value. It itself is based on the further belief that all income which is due to the performance of labor is wages and that all who work are wage earners. It is on the basis of these beliefs that Adam Smith opens his chapter on wages in *The Wealth of Nations* with the words:

The produce of labour constitutes the natural recompense or wages of labour. In that original state of things, which precedes both the appropriation of land and the accumulation of stock, the whole produce of labour belongs to the labourer. He has neither landlord nor master to share with him.

And Smith continues, a little further on:

But this original state of things, in which the labourer enjoyed the whole produce of his own labour, could not last beyond the first introduction of the appropriation of land and the accumulation of stock. It was at an end, therefore, long before the most considerable improvements were made in the productive powers of labour, and it would be to no purpose to trace further what might have been its effects upon the recompense or wages of labour.

As soon as land becomes private property, the landlord demands a share of almost all the produce which the labourer can either raise or collect from it. His rent makes the first deduction from the produce of the labour which is employed upon the land.

It seldom happens that the person who tills the ground has the wherewithal to maintain himself till he reaps the harvest. His maintenance is generally advanced to him from the stock of a master, the farmer who employs him and who would have no interest to employ him, unless he was to share in the produce of his labour, or unless his stock was to be replaced to him with a profit. This profit makes a second deduction from the produce of the labour which is employed upon land.

The produce of almost all other labour is liable to the like deduction of profit. In all arts and manufactures the greater part of the workmen stand in need of a master to advance them the materials of their work, and their wages and maintenance till it be completed. He shares in the produce of their labour, or in the value which it adds to the materials on which it is bestowed; and in this share consists his profit.⁵

⁵ Adam Smith, [The Wealth of Nations, Cannan Edition](#), Bk. I, Chap. VIII.

In these passages, Smith clearly advances what I call the primacy of wages doctrine. That is, the doctrine that in a pre-capitalist economy—the “early and rude state of society”—in which workers simply produce and sell commodities and do not buy in order to sell, the incomes the workers receive are wages. Wages are the original income, according to Smith. All income in the pre-capitalist society is supposed to be wages, and no income is supposed to be profit, according to Smith, because workers are the only recipients of income. At the same time, of course, Smith advances the corollary doctrine that profit emerges only with the coming of capitalism and is a deduction from what is naturally and, by implication, rightfully wages.

These doctrines, as I say, constitute the conceptual framework of the exploitation theory. They are the starting point for Marx.

In a pre-capitalist economy, production, says Marx, is characterized by the sequence C-M-C. In this state of affairs, a worker produces a commodity C, sells it for money M, and then buys other commodities C. In this state of affairs, there is no exploitation, for there are no profits, no “surplus value”; all income is, presumably, wages. Surplus value, profit, emerges only with the development of capitalism, according to Marx. Here the sequence M-C-M' applies. Under this sequence, the capitalist expends a sum of money M in buying materials and machinery and in paying wages. A commodity C is produced, which is then sold for a larger sum of money, M', than was expended in producing it. The difference between the money the capitalist expends and the money he receives for the product is his profit or surplus value.⁶

Profits, then, according to both Smith and Marx, come into existence only with capitalism, and are a deduction from what naturally and rightfully belongs to the wage earners.

This is not yet the exploitation theory itself, only the conceptual framework of the exploitation theory. It is a framework broad enough to include Marx, the leading proponent of the exploitation theory, and Böhm-Bawerk, its leading critic.

Within this framework, Marx applies the labor theory of value and the iron law of wages, and arrives at the exploitation theory. Within this same framework, Böhm-Bawerk applies the discounting approach, and arrives at a critique of the exploitation theory.⁷ Both men call upon their respective doctrines to explain what makes possible the alleged deduction of profits from wages and what determines the size of this deduction.

Böhm-Bawerk's explanation is that present goods are more valuable than future goods, and that the wage earner is justly treated in being given a smaller sum of present money

⁶ Karl Marx, [*Das Kapital, Vol. I. Pt. II, Chap. IV.*](#)

⁷ [*Ibid., passim*](#); Böhm-Bawerk, *Capital and Interest, op. cit.*, Vol. I, pp. 263-71; Vol. II, pp. 259-89, *passim*.

than his future product will be worth. Marx's explanation is that the capitalist arbitrarily pays the wage earner a wage corresponding to the number of hours required to produce the wage earner's necessities and sells the wage earner's product at a price corresponding to the—larger—number of hours for which the wage earner works.

Now, in my view, the fundamental place to challenge the exploitation theory is not over the labor theory of value or the iron law of wages, but here, over its conceptual framework—over the doctrines of the primacy of wages and the deduction of profits from wages. Furthermore, it is precisely classical economics itself which provides the means for making this challenge. For classical economics implies that it is false to claim that wages are the original form of income and that profits are a deduction from them. This becomes apparent, as soon as we define our terms along classical lines:

“Profit” is the excess of receipts from the sale of products over the money costs of producing them—over, it must be repeated, *the money costs* of producing them.

A “capitalist” is one who buys in order subsequently to sell for a profit.

“Wages” are money paid in exchange for the performance of labor—not for the products of labor, but for the performance of labor itself.

On the basis of these definitions it follows that, if there are merely workers producing and selling their products, the money which they receive in the sale of their products is *not* wages. “Demand for commodities,” to quote John Stuart Mill, “is not demand for labour.”⁸ In buying commodities, one does not pay wages, and in selling commodities, one does not receive wages.

In the pre-capitalist economy, if such an economy ever in fact existed, all income recipients in the process of production are workers. But the incomes of those workers are not wages. They are, in fact, *profits*. Indeed, *all* income earned in producing products for sale in the pre-capitalist economy is profit or “surplus value”; no income earned in producing products for sale in such an economy is wages. For what the workers of a pre-capitalist economy receive are *receipts from the sale of products*. But they have no money costs of production to deduct from those sales receipts, for they have not acted as capitalists: They have not bought anything for the purpose of making possible their sales receipts, and therefore they have no money costs. The difference between receipts from the sale of products and zero money costs of production is the full magnitude of the sales receipts.

Thus, in the pre-capitalist economy, only workers receive incomes and there is no money capital. But all the incomes which the workers receive are profits, and none are wages. In the sequence C-M-C, everything is “surplus value”—one-hundred percent of the sales receipts and an infinite percentage of the zero money capital. In the sequence M-C- M', a

⁸ John Stuart Mill, *Principles of Political Economy*, *op. cit.*, Bk. I, Chap. V, Sec. 9.

smaller proportion of the incomes is “surplus value”—in degree that M is large relative to M’.

This same conclusion, that in the pre-capitalist economy all income is profit, and no income is wages, can be arrived at by way of Ricardo’s badly misunderstood proposition that “profits rise as wages fall and fall as wages rise.” The wages paid in production, according to Ricardo, are paid by capitalists, not by consumers. If, as in the pre-capitalist economy, there are no capitalists, then there are no wages paid in production, and if there are no wages paid in production, the full income earned must be profits.

Smith and Marx are wrong. Wages are not the primary form of income in production. Profits are. In order for wages to exist in production, it is first necessary that there be capitalists. The emergence of capitalists does not bring into existence the phenomenon of profit. Profit exists prior to their emergence. The emergence of capitalists brings into existence the phenomena of wages and money costs of production.

Accordingly, the profits which exist in a capitalist society are not a deduction from what was originally wages. On the contrary, the wages and the other money costs are a deduction from sales receipts—from what was originally all profit. The effect of capitalism is to create wages and to reduce profits relative to sales receipts. The more economically capitalistic the economy—the more the buying in order to sell relative to the sales receipts, the higher are wages and the lower are profits relative to sales receipts.

Thus, capitalists do not impoverish wage earners, but make it possible for people to be wage earners. For they are responsible not for the phenomenon of profits, but for the phenomenon of wages. They are responsible for the very existence of wages in the production of products for sale. Without capitalists, the only way in which one could survive would be by means of producing and selling one’s own products, namely, as a profit earner. But to produce and sell one’s own products, one would have to own one’s own land, and produce or have inherited one’s own tools and materials. Relatively few people could survive in this way. The existence of capitalists makes it possible for people to live by selling their labor rather than attempting to sell the products of their labor. Thus, between wage earners and capitalists there is in fact the closest possible harmony of interests, for capitalists create wages and the ability of people to survive and prosper as wage earners. And if wage earners want a larger relative share for wages and a smaller relative share for profits, they should want a higher economic degree of capitalism—they should want more and bigger capitalists.

Historical confirmation of the theory I am propounding can be found in Prof. Hayek’s Introduction to *Capitalism and the Historians*. There we find such statements as: “The actual history of the connection between capitalism and the rise of the proletariat is almost the exact opposite of that which these theories of the expropriation of the masses suggest.” And: “The proletariat which capitalism can be said to have ‘created’ was thus not a proportion of the population which would have existed without it and which it

degraded to a lower level; it was an additional population which was enabled to grow up by the new opportunities for employment which capitalism provided.”⁹

The correct theory, as well as the actual history, is the exact opposite of the doctrine of the primacy of wages.

Profits and Labor: The Productive Contribution of Businessmen and Capitalists

In a pre-capitalist economy, the income of labor is profit, and profit is thus obviously a labor income. In a capitalist economy, too, there are many instances in which profits are obviously a labor income: all the cases in which businessmen perform labor in their own enterprises, whether in a managerial or manual capacity. Yet the practice of economics—in disregard of that of accounting and of business itself—has been to classify all such income as wages, and to reserve the term profit (most of which it has come to call interest) for describing income received by virtue of the ownership of capital.

I shall argue that in a capitalist economy, no less than in a pre-capitalist economy, profit is still a labor income—an income attributable to the labor of businessmen and capitalists—and that this is so even though profits are for the most part earned as a rate of return on capital and tend to vary with the amount of capital invested.

The variation of profits with the size of the capital invested is perfectly compatible with their being attributable to the labor of those who earn them, because in a capitalist economy the labor of profit earners tends to be predominantly of an intellectual nature—a work of thinking, planning, and decision making. At the same time, capital stands as the means by which businessmen and capitalists implement their plans—it is their means of buying the labor of helpers and of equipping those helpers and providing them with materials of work. Thus, the possession of capital serves to multiply the efficacy of the businessmen’s and capitalists’ labor, for the more of it they possess, the greater is the scale on which they can implement their ideas. For example, a businessman who thinks of a better way to produce something can apply that better way on ten times the scale if he owns ten factories than if he owns only one. The fact that in the one case the same labor on his part leads to ten times the profit as in the other case is perfectly consistent with the whole profit still being attributable to his labor.

The compound variation of profits with the passage of time is also perfectly consistent with the fact that they are the product of the businessmen’s and capitalists’ labor. The relationship of profits to the passage of time derives from the fact that profits vary with the size of the capital invested per period of time. If one can earn profits in proportion to one’s capital in any given period of time, then if investment for a longer period is to be competitive, one must earn the profits that one could have earned in the shorter period plus the profits one could have earned by the reinvestment of one’s capital and its profits.

⁹ F. A. Hayek, editor, *Capitalism and the Historians* (Chicago: University of Chicago Press, 1954), pp. 15f.

It should be realized that wages, too, which no one disputes are attributable to the labor of the wage earners, vary with things other than the expenditure of labor by the wage earners—for example, with the state of technology and the supply of capital equipment and with competitive conditions in other industries. For an income to be attributable to labor, it is by no means necessary that the performance of labor be the only factor determining its size. In fact, by such a standard, virtually nothing could be attributed to human labor beyond what people could produce with their bare hands. Income is to be attributed to the performance of labor, despite its variation with the means employed and with other external circumstances, on the principle that it is man's labor which supplies the guiding and directing intelligence in production. It is only on this basis that a worker using a steam shovel, for example, is to be credited with digging the hole he digs, no less than a worker using his bare hands, for he guides and directs the steam shovel.

Guiding and directing intelligence, not muscular exertion, is the essential characteristic of human labor. As von Mises says, "What produces the product are not toil and trouble in themselves, but the fact that the toiling is guided by reason."¹⁰ Guiding and directing intelligence in production is, of course, supplied by businessmen and capitalists on a higher level than by wage earners—a circumstance reinforcing the primary productive status of profits and profit earners over wages and wage earners.

I would like to note that the attribution of profits to the labor of businessmen and capitalists is also perfectly consistent with their simultaneously reflecting the general state of time preference in the economic system. Time preference operates to determine the general rate of return on capital, which businessmen and capitalists then earn or not on the basis of their individual productive accomplishments. Perhaps a useful analogy is the fact that consumer demand determines the general earnings of workers of a given degree of skill in comparison with those of workers of a different degree of skill. Yet, at the same time, each individual worker is responsible for his own earnings. This is merely a restatement of the principle that income is attributable to labor even though it varies with other factors as well. In the case of profit, one of those other factors, operating as a general determinant, is time preference.

The precise nature of the work of businessmen and capitalists needs to be explained. In essence, *it is to raise the productivity, and thus the real wages, of manual labor by means of creating, coordinating, and improving the efficiency of the division of labor.*

Businessmen and capitalists create division of labor in founding and organizing business firms and in providing capital. Business firms are the central units of the division of labor: they represent a division of labor externally, in the division of tasks between the different firms and industries, and internally, in the breakdown of tasks among different divisions, departments, and individual workers within the firms. The provision of capital is indispensable to the existence of the division of labor in its vertical aspect, that is, to a

¹⁰ Cf. Ludwig von Mises, [*Human Action, Third Revised Edition \(Chicago: Henry Regnery Company, 1966\), p. 142.*](#)

succession of workers each beginning his work where others leave off. In its absence, workers would have to wait to be paid by the ultimate consumers. In many cases, such as the production of durable equipment, the construction of buildings, and, still more, of factories producing durable equipment, including durable equipment for the further construction of such factories, this would entail a waiting time extending beyond the lifetimes of the workers, and even beyond the lifetimes of their children. The provision of capital, therefore, introduces a necessary division of payments, as it were, which permits producers to be paid within a reasonable period of time after performing their work. And the more capitalistic—the more capital intensive—the economic system, the larger is the proportion of the labor force which can be employed in the production of temporally more remote consumers' goods.¹¹

Businessmen and capitalists coordinate the division of labor in seeking to avoid losses and to earn higher rates of return on their capital in preference to lower rates of return. For in so doing, they are led to try to avoid over-expanding any industry relative to other industries and, at the same time, to be sure that any industry that is insufficiently expanded relative to other industries is further expanded. This is a major aspect of the significance of the principle, so well developed by the classical economists, that there is a tendency toward a uniform rate of profit on capital invested in all branches of industry.¹² In addition, the managerial activity of businessmen and capitalists represents a coordination of the internal division of labor in their firms.

Finally, businessmen and capitalists continuously improve the efficiency of production as the result both of their competitive quest for exceptional rates of profit and their saving and investment for the purpose of accumulating personal fortunes. The only way to earn an exceptional rate of profit where the legal freedom of competition prevails is by being an innovator in the production of better products or equally good but less expensive products. The exceptional profits from any given innovation then disappear as competitors begin to adopt it and make it into the normal standard of an industry. This requires that one introduce *repeated* innovations as the condition of continuing to earn an exceptional rate of profit. In this way, the entire benefit of every innovation tends to be passed forward to the consumers in the form of better products and lower prices, with exceptional profits being entirely transitory in the case of each particular innovation and a permanent phenomenon only insofar as improvement is continuous.¹³

¹¹ Cf. Böhm-Bawerk, *Capital and Interest*, *op. cit.*, Vol. I, pp. 263-71; Vol. II, pp. 105ff; Hayek, *Prices and Production*, revised edition, (London: Routledge & Kegan Paul, 1935; reprint, Fairfield, New Jersey: A. M. Kelley, 1967), *passim*.

¹² Cf. [Adam Smith](#), *op. cit.*, Bk. I, Chap. X, Pt. I; David Ricardo, [Principles of Political Economy and Taxation](#), Third Edition, (London: 1821), Chap. IV. See also Reisman, [Capitalism](#), pp. 172-180.

¹³ Successful anticipation of changes in consumer demand ahead of others is also an important way to make an exceptional rate of profit, and serves greatly to increase the benefits derived from economic progress. On this subject, see [Capitalism](#), *op. cit.*, p. 179.

The saving of businessmen and capitalists to accumulate personal fortunes operates to achieve economic progress by ensuring that a sufficiently high proportion of the economic system's ability to produce is devoted to the production of capital goods, with the result that each year's production can begin with the existence of more capital goods than were available the year before. Their saving and investment has this effect by virtue of raising the demand for capital goods relative to the demand for consumers' goods, and thus of making profitable the greater relative production of capital goods. (A further aspect of this saving and investment is that the demand for labor is raised relative to the demand for consumers' goods.)

In the light of these facts about the nature of the productive contribution of businessmen and capitalists, it is possible to revise the classical doctrine of the labor theory of value in a way that helps to explain a steady rise in real wages and which nullifies the so-called iron law of wages. And that is simply this: In steadily raising the productivity of manual labor, the businessmen and capitalists are constantly reducing the quantity of labor required to produce virtually every good. The effect of this is steadily to reduce prices relative to wages, i.e., to raise real wages.

It should be realized that the same result follows if we view both wages and prices as being determined by demand and supply in the classical sense— i.e., by the ratio of expenditure to quantity sold. Viewed in this light, a rise in the productivity of labor increases the supply of goods relative to the supply of labor and therefore reduces prices relative to wage rates. It should also be realized that this account of matters incorporates both the wages fund doctrine and Ricardo's doctrine of the distinction between "value and riches"— the former, in its implication of a distinct and given demand for labor; the latter, in its perception of the rise in real wages as proceeding not from a rise in money incomes but from a fall in prices, which is the natural consequence of a greater ability to produce.¹⁴ Thus, to admit that product prices are determined by the quantity of labor required to produce goods does not at all lead to the exploitation theory, provided one adds that businessmen and capitalists are responsible for the continuing reduction of that quantity and, therefore, for a continuing reduction in prices relative to wages.

Of course, it must be made crystal clear, which the classical economists never succeeded in doing, that the quantity of labor as a determinant of prices is strictly confined to the category of reproducible products. Major categories of prices are in no way determined by it—above all, wage rates. Such prices are determined by supply and demand—by marginal utility, including the utility of marginal products. Nor are wages connected even indirectly with the "cost of production of labor."

The growth of population in a division-of-labor, free-market society does not require the cultivation of progressively inferior soils under conditions of diminishing returns, until the point is reached where the productivity of labor on the "land last cultivated" yields

¹⁴ [Ricardo, *op. cit.*](#), Chap. I, Sec. VII; Chap. XX.

only subsistence, as Ricardo often, but not always, maintained.¹⁵ On the contrary, in such a society (a society which is capitalistic in the full sense of the term, i.e., incorporating economic freedom), population growth means that the division of labor can be carried further and that those branches of it which are concerned with the discovery of new knowledge and its application to production can be carried on on a larger scale. Thus the effect of rising population in such a society is actually to raise the productivity of labor and real wages.

This conclusion, I believe, follows from Adam Smith's principle that "the division of labor is limited by the extent of the market."¹⁶ It also rests on the fact that private ownership of land and natural resources provides the incentive to steadily raise the productivity of the land, with the result that as time goes on the poorest farms and mines worked yield more than the best farms and mines previously worked, and the point from which returns diminish rises steadily higher.

Once it is recognized that money wages are determined strictly by supply and demand, then it becomes clear that the wage earner's presumable willingness to work for a subsistence wage rather than die of starvation, and the capitalist's preference, other things equal, to pay lower wages rather than higher wages, are both irrelevant to the wage the worker must actually be paid. That wage is determined by the demand for and supply of labor. It can fall no lower than corresponds to the point of full employment. If it drops below that point, a labor shortage is created, which makes it to the self-interest of employers able and willing to pay a higher wage to bid wages up, so that they do not lose employees to other employers not able or willing to pay as much.

Moreover, a fall in wages toward the full employment point does not represent the possibility of subsistence wages being achieved through the back door, as it were, because it is accompanied by a fall both in product prices and in the burden of supporting the unemployed. The fall in wages implies a fall in prices both on the principle of cost of production and on the principle of supply and demand, for the lower wages mean not only lower costs but also more employment, therefore, more production, and, therefore, a larger supply of goods coming to market. The fall in prices together with a reduction in the burden of supporting the unemployed almost certainly means a rise in real "take-home" wages.

The rising productivity of labor and correspondingly falling product prices that the businessmen and capitalists achieve take place in this context of wage rates that are determined by the independent supply of and demand for labor. Thus, as product prices fall, wage rates do not fall, and, therefore, real wages rise. (If, the quantity of money and volume of spending in the economic system remaining the same, there is a growing supply of labor while the productivity of labor rises, money wage rates fall, but prices fall by more.) Of course, to the extent that the quantity of money increases while the

¹⁵ *Ibid.*, Chap. V.

¹⁶ *Smith, op. cit.*, Bk. I, Chap. III.

productivity of labor rises, the demand for labor and products both increase. As a result, the rise in real wages may be accompanied by rising money wage rates and by constant or even rising product prices. But the relationship between wages and prices will reflect the change in the productivity of labor, for that reduces product prices relative to wages, while the increase in the quantity of money operates to affect both of them more or less equally. (Under a gold standard, there would be a modest rate of increase in the quantity of money, which would probably be accompanied by falling prices and rising money wages.)

So much for the “iron law of wages” in all its variations.

Of course, even within the domain of reproducible products, quantity of labor is by no means the only determinant of price. As Ricardo himself explained in Sections IV-VI of his chapter on value, the period of time for which profits must compound on wages before the ultimate, final product is sold to consumers is a second major determinant of prices.¹⁷ (In my opinion, Ricardo’s discussion of the time factor is in some respects more insightful even than Böhm-Bawerk’s. Certainly, after reading those sections, there is every reason for believing that he would have been fully in accord with all of the essential points of Böhm-Bawerk’s *Karl Marx and the Close of His System*.¹⁸ Indeed, many people may find remarkable Ricardo’s statement to McCulloch: “I sometimes think that if I were to write the chapter on value again which is in my book, I should acknowledge that the relative value of commodities was regulated by two causes instead of by one, namely, by the relative quantity of labour necessary to produce the commodities in question, and by the rate of profit for the time that the capital remained dormant, and until the commodities were brought to market.”¹⁹)

In addition, wage rates themselves and prices of various materials determined by supply and demand are further factors entering into the determination of prices even in the domain where quantity of labor is relevant.²⁰ And, as previously indicated, of course, determination of price by cost is never an ultimate determination, for the prices that constitute the costs are themselves determined by supply and demand and reflect the utility of marginal products, as Böhm-Bawerk so brilliantly explained.²¹ And, to be sure,

¹⁷ Cf. [Ricardo, *op. cit.*](#), Chap. I.

¹⁸ Eugen von Böhm-Bawerk, *Karl Marx and the Close of His System*, translated by Alice Macdonald (New York: The Macmillan Company, 1898; reprint, New York: Augustus M. Kelley, 1949). This essay is also reprinted under the title “Unresolved Contradiction in the Marxian Economic System” in *Shorter Classics of Böhm-Bawerk* (South Holland, Illinois: Libertarian Press, 1962).

¹⁹ Cf. *The Works and Correspondence of David Ricardo*, Piero Sraffa, Editor (Cambridge, England: The Syndics of the Cambridge University Press, 1952), Vol. VIII, p. 194.

²⁰ John Stuart Mill comes very close to an accurate statement of all the relevant factors in his chapter on the ultimate analysis of cost of production. Cf. [Mill, *op. cit.*, Bk. III, Chap. IV.](#)

²¹ Cf., above, note 2.

there are product prices which have no connection whatever to quantity of labor or cost of production in any form, but are determined exclusively by supply and demand, as Ricardo himself pointed out.²²

A Radical Reinterpretation of Labor's Right to the Whole Produce

The fact that profits are an income attributable to the labor of businessmen and capitalists, and the further fact that their labor represents the provision of guiding and directing intelligence at the highest level in the productive process, suggests a radical reinterpretation of the doctrine of labor's right to the whole produce. Namely, that that right is satisfied when first the full product and then the full value of that product comes into the possession of *businessmen and capitalists* (which is exactly what occurs, of course, in the everyday operations of a market economy). For *they*, not the wage earners are the fundamental producers of products.

By the standard of attributing results to those who conceive and execute their achievement at the highest level, one must attribute to businessmen and capitalists the entire gross product of their firms and the entire sales receipts for which that product is exchanged. Such, indeed, is the accepted standard in every field outside of economic activity. For example, one attributes the discovery of America to Columbus, the victory at Austerlitz to Napoleon, the foreign policy of the United States to its President (or at most a comparative handful of officials). These attributions are made despite the fact that Columbus could not have made his discovery without the aid of his crewmen, nor Napoleon have won his victory without the help of his soldiers, nor the foreign policy of the United States be carried out without the aid of the employees of the State Department. The *help* these people provide is perceived as the means by which those who supply the guiding and directing intelligence at the highest level accomplish *their* objectives. The intelligence, purpose, direction, and integration flow down from the top, and the imputation of the result flows up from the bottom.

By this standard, the product of the old Ford Motor Company and the Standard Oil Company are to be attributed to Ford and Rockefeller. (In many cases, of course, the product must be attributed to a group of businessmen and capitalists, not just to a single outstanding figure.) In any event, labor's right to the full value of its produce is fully satisfied precisely when a Rockefeller or Ford, or their less known counterparts, are paid by their customers for *their* products. The product is theirs, not the employees'. The help the employees provide is fully remunerated when the producers pay them wages.

This view of the nature of labor's right to the full produce leads to a very different view of the payment of incomes to capitalists whose role in production might be judged to be passive, such as, perhaps, most minor stockholders and the recipients of interest, land rent, and resource royalties. If the payment of such incomes did represent an exploitation of labor, it would not be an exploitation of the labor of wage earners. Such incomes are

²² Cf. [Ricardo. *op. cit.*](#), Chap. I, Sec. I.

paid by businessmen—by the active capitalists; they are not a deduction from wages but from *profits*. If any exploitation were present here, it would be this group, not the wage earners, who were the exploited parties. What this would mean in practice is that individuals like Rockefeller and Ford were exploited by widows and orphans, for it is such individuals who make up a large part of the category of passive capitalists. In fact, however, the payment of such incomes is never an exploitation, because their payment is a source of gain to those who pay them. They are paid in order to acquire assets whose use is a source of profits over and above the payments which must be made. Furthermore, the recipients of such incomes need not be at all passive; they may very well earn their incomes by the performance of a considerable amount of intellectual labor. Anyone who has attempted to manage a portfolio of stocks and bonds or real estate should know that there is no limit to the amount of time and effort which such management can absorb in the form of searching out and evaluating investment possibilities, and that the job will be better done the more such time and effort one can give it. In the absence of government intervention in the form of the existence of national debts, loan guarantees, and deposit insurance, (not to mention “transfer payments”), the magnitude of truly unearned income in the economic system would be quite modest, for almost every other form of investment would require the exercise of some significant degree of skill and judgment. Those not able or willing to exercise such skill and judgment would either rapidly lose their funds or would have to be content with very low rates of return in compensation for safety of principal and, possibly, reflecting the deduction of management fees by trustees or other parties.

It should also be realized that in a *laissez faire* economy, without personal or corporate income taxes (a real exploitation of labor) and without legal restrictions on such business activities as insider trading and the award of stock options, the businessmen and active capitalists are in a position to own an ever increasing share of the capitals they employ. With their high incomes they can progressively buy out the ownership shares of the passive capitalists.

In this way, under capitalism, those workers—the businessmen and active capitalists—who do have a valid claim to the ownership of the industries *in fact come to own them*. Again and again, penniless newcomers appear on the scene and by virtue of their success secure a growing influence over the conduct of production and ultimately obtain the ownership of vast personal fortunes. An ironic consequence of Adam Smith’s errors in this area, to be counted among all the other absurdities of socialism, is that the socialists want to give the ownership of the industries *to the wrong workers!* And to do so, they want to destroy the economic system which gives it to the right workers. They want to give it to the manual laborers, while capitalism gives it to those who supply the guiding and directing intelligence in production.

Not surprisingly, the socialists and their fellow travelers, the contemporary “liberals,” denounce capitalism’s giving ownership to the right workers. They denounce it when they denounce large salaries and stock options for key executives.

Exploitation and Socialism

As a final irony it turns out not only that capitalism is not a system of the exploitation of labor, but that the actual system of the exploitation of labor is *socialism*. Socialism establishes the very kind of exploitation for the alleged existence of which people seek to overthrow capitalism.

The socialist state holds a universal monopoly on employment and production. Its citizens are economically powerless in their capacity both as workers and as consumers. No economic factor compels the socialist state to take account of their wishes. From an economic point of view, the rulers of the socialist state need be concerned with the values of the citizens only insofar as it needs them to have the health and strength required to work.

Moreover, the leading moral-political principle of the socialist state is that the citizen is not an end in himself, as he is acknowledged to be under capitalism, but is a means to the ends of “society.” Since society does not inhabit any known mountain top, and cannot be communicated with in any direct way, its ends can be made known only through the rulers of the socialist state. Thus, the principle that the individual is the means to the ends of society necessarily means, in practice, that he is the means to the ends of society *as divined, interpreted, and determined by the rulers of the socialist state*. And what *this* means is that he is the means to *the ends of the rulers*. A more servile arrangement can hardly be imagined.

Thus, the position of the individual under socialism is that he must spend his life in toil for the ends of the rulers, who have no reason voluntarily to supply him with anything more than minimum physical subsistence. They will provide more (assuming they have the ability to do so) only if it is necessary to prevent riots or revolution or as a means of providing special incentives for the achievement of their own values, such as, above all, the power and prestige of the regime. Thus, they will provide a relatively high standard of living for rocket scientists, secret police agents, and such intellectuals and athletes whose accomplishments help to reflect glory on the regime. The average citizen, however, is fortunate if they provide him with subsistence. He is fortunate, because, as Mises and Hayek have shown, the economic discoordination and chaos of socialism is so great that in the absence of an outside capitalist world to turn to for aid, socialism would lead to the destruction of the division of labor and hence to a reversion to the primitive economic conditions of feudalism. To borrow some of the clichés of Marxism and use them truthfully for once, socialism “cannot even maintain its slaves in their slavery”; left to its own devices, it causes the average worker “to sink deeper and deeper into poverty,” until mass depopulation occurs.²³

²³ Cf. von Mises, *Socialism* (New Haven: 1951; reprint, Indianapolis: Liberty Classics, 1981), pp. 113–42, pp. 211–20, pp. 516–21; *Human Action, op. cit.*, pp. 698–715; Hayek, *The Road to Serfdom, op. cit.*, pp. 48–50; idem, editor, *Collectivist Economic Planning* (London: George Routledge & Sons, 1935); Reisman, *Capitalism*, pp. 275–278, 288–290.

Summary and Conclusion

Despite the support which it historically gave to the exploitation theory, classical economics provides the basis for turning the exploitation theory upside down. On the basis of Ricardo's concept of profit and J. S. Mill's proposition that "demand for commodities is not demand for labour," it makes it possible to show how profits, not wages, must be regarded as the original and primary form of income, from which other incomes emerge as a deduction. And, further, not only how profits are a labor income (despite their variation with the size of the capital invested and the period of time for which it is invested), but how the labor of businessmen and capitalists has more fundamental responsibility for the production of products than the labor of wage earners, with the result that "labor's right to the whole produce" should mean the right of businessmen and capitalists to the sales receipts—a right which is honored every day, in the normal operations of a capitalist economy. In addition, the classical doctrines of supply and demand, the wage fund, the distinction between value and riches, and even the labor theory of value (appropriately modified along lines suggested by Ricardo and J. S. Mill and incorporating the advances in price theory made by Böhm-Bawerk) make possible an explanation of real wages based on the productivity of labor, which it is the economic function of businessmen and capitalists steadily to increase. Finally, it can be shown how socialism, with its universal state monopoly on employment and supply, is the economic system to which the exploitation theory actually applies.