Contents

Acknowledgments vii
Preface ix
Summary xi

Part One: Principles
1 Economic Freedom 3
2 Natural Law 6
3 The Significance of Land 13

Part Two: The Theory of the Firm Re-Examined
4 Perfect Competition 25
5 Monopolistic Competition 39
6 Monopoly 47
7 Oligopoly 57

Part Three: Factor Incomes
8 The Law of Rent 71
9 Transfer Earnings of Factors 90
10 Wages 96
11 Capital 109
12 Profit 123

Part Four: Money and Value
13 Money, Credit and Interest 137
14 Value and Price 154

Part Five: Public Revenue
15 Taxation 171
16 Historical Analysis 188
17 Externalities 196
18 Natural Monopoly 205
19 Housing 214

Part Six: Macro-Economics

20 Outline of Macro-Economic Theory 231
21 Critique of the Theory: Land 256
22 Critique of the Theory: Money and Credit 273
23 Critique of the Theory: Taxation 285
24 The Model Reformed 291
25 The Reformed Economy and World Trade 308
26 Business Cycles 313

Part Seven: Conclusions

27 Practical Problems of Rent as Public Revenue 325
28 Justice 335

Appendix: Rent and Landlord's Claim 339
Select Bibliography 341
Index 343

Preface

THIS BOOK is the outcome of many years study of Economics from two rather different standpoints. On the one hand, my study of modern academic Economics began at Balliol College, Oxford, and continued through a long career of teaching the subject and editing an economics journal. On the other hand, I have studied and taught for almost as long at the School of Economic Science in London and Oxford, where the fundamental principles of the subject, rather than its ever-changing theories and multitudinous empirical facts and statistics, have been the central issue.

An analogy may help to put these two standpoints into perspective. Building a house requires both firm foundations and a well designed, aesthetically pleasing superstructure. Modern academic Economics provides the latter, but not, in my view, the former. It is a fine house, built upon foundations which are askew. Hence it leans dangerously, and might even collapse in a welter of broken theories and dubious 'facts'. One hopes that the real economies which it purports to explain do not similarly come to grief. Cracks are certainly appearing at the time this book is published. Over half a century of research and teaching by the School of Economic Science, however, has yielded a set of principles revealed by reason and by careful examination of economic thinkers in the tradition of natural law. Upon the foundation of these principles this book attempts to construct a new house of Economics from the materials offered by modern analysis.

A growing awareness of the inadequacy of existing economic orthodoxy is evident from a number of books and articles that have appeared in recent years, such as *A Guide to What's Wrong with Economics* (ed. E. Fulbrook, Anthem Press, 2004). It is in response to this need for a new kind of economic model that this book is offered. The model presented is not mathematical; it is rather an amendment of the present framework of micro and macro economic analysis by changing the assumptions. In particular, it removes the 'flat-earth' assumption of homogenous land. As Eaton and Lipsey – two economists who have realised the importance of land in economic theory

– have written, 'many phenomena that appear inexplicable when inserted into a spaceless model are explicable in a spatial model.' (*On the Foundations of Monopolistic Competition and Economic Geography*, Edward Elgar, 1997). *The New Model of the Economy* hopes to restore the spatial model that the founders of Economics, such as Ricardo, had in mind.

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Summary

PART ONE affirms some fundamental principles, which underpin the main arguments, although they are not always explicitly recalled. They are, in brief, that the purpose of the study of Economics is to enhance human freedom, that natural law underlies all economic phenomena, and that land, as defined by economists, is a prime factor of production, not just in the third world, but in all advanced industrial economies, alongside the natural forces of the universe and human labour.

Human freedom has a variety of aspects (Chapter 1). On the highest level it is spiritual or philosophical, and concerns the nature of the self and the very essence of humanity. On the political level it concerns one's relationship to the State and the forms of government most suited to particular peoples and times. On the civil level it is a matter of the individual's recognition of law, and the nature of laws that deal with violence, defamation, personal property and so on. But, on the level of the economy, freedom is above all the ability to use one's creative powers to the full. Productive work is the principal means of expressing oneself. Today such a concept of freedom tends to be limited to the fortunate few whose special talents and opportunities enable them so to express themselves – actors, artists, sportsmen, self-employed craftsmen and successful entrepreneurs, for example. The majority of people are assumed to be suited to be employees, often in repetitive or tedious occupations. Their principal motive for work degenerates into earning sufficient to maintain themselves and their families in a modest standard of living. What then so inhibits their natural freedom? The study of the limitations on human creativity through work, and how they might be removed, is the theme of this book.

The second principle, which is also given scant recognition in modern economic thought, is that economic activity is subject to natural law (Chapter 2). Whilst modern physical sciences are largely built upon the idea that phenomena are governed by laws, the social sciences have

been beset by apparent difficulties in establishing laws and a resulting recourse to statistical generalisation. However, in Chapter 2 I have attempted to show that some of the simplest and least controversial operations of any economy are governed by natural law. The argument is not philosophical. It is just that certain highly predictable and regular forms of behaviour occur so commonly as to be suitably categorised as law-like. They follow from human nature, which is itself a controversial concept if examined in depth, but for the purposes of Economics can be quite well known by observation. There is, for example, a division of labour in all modern societies, however they are organised politically and socially. Plato and Adam Smith observed it before we did. What is more controversial, of course, are the implications drawn later in this book that such matters as the general level of wages and the impact of taxation are similarly law-like.

The third principle under discussion is the significance of land in the economy (Chapter 3). This is the first major point of departure from conventional economic analysis. When that economy is not a typical capitalist one, then land tenure may become an important ingredient in its analysis, but when it is the economy of the UK or the USA, for example, then the present system of private property in land is indeed taken for granted or ignored. Yet this system literally and conceptually underlies the whole operation of the economy built upon it. To give but one instance from many that are explored in detail later in the book: consider what kind of competitive relationship exists between two firms in the same industry, one of which owns a freehold site in the centre of a large city and the other rents a site nearby. The former pays nothing to a landowner. The latter pays a large annual rent. Yet they must sell their products at similar prices. Is this competition; if so, of what kind? Any analysis that ignores this is futile. Yet the standard economic analysis does ignore it.

Another aspect of the current neglect of land in economic theory is that too often land is subsumed under the heading of capital. Yet, at least since Ricardo, it has been clear that the part played by land in any economy is radically different from that of capital, either in its proper sense of produced means of production or in its looser sense of money loaned for the purchase of capital goods or other assets. Why is this? As Ricardo so carefully explained, land gives rise to rent. But so does capital in certain circumstances, says the conventional wisdom. This spurious reply is dealt with in Chapter 8 below; here it is sufficient to say that the concept of rent in modern economic thought is thoroughly ambiguous.

Part Two follows closely the pattern of micro-economic analysis found in textbooks (Chapters 4-7). Its *modus operandi* is simple. The firm is redefined as a one-site productive unit (sometimes this condition is relaxed to deal with multi-site enterprises.). The economic rent of land is explicitly shown in each of the four cases of perfect competition, monopolistic competition, monopoly and oligopoly. This is not merely the extraction of rent payments to landlords. For the whole point is to show how economic rent, properly defined as the potential annual value of a site i.e. Ricardian rent, enters into economic activity, profoundly affecting the competitive situation of firms. This inevitably involves distinctions being made between firms with freehold or leasehold land and those paying a full rent to landlords, crucial facts usually ignored in economic analysis. A striking example of the impact of making economic rent explicit is the case of firms holding mineral-rich land, such as oil companies. Once the land is acquired – which historically may have been by force or fraud – nothing is charged against their profits for land costs. Hence their recorded profits are substantially economic rent, a return to land, not a return to either capital or entrepreneurship. There are many similar examples of the failure of micro-economic analysis to trace correctly the proper economic source of streams of income. Oddly enough present-day economic conditions are revealing this in strange ways. For example, private equity firms are becoming aware that supermarkets have property interests that are more valuable than their goodwill as retailers.

One conclusion of this fresh analysis of the theory of the firm is that perfect competition can be seen to have much wider application that is currently thought, if it is taken to be a 'level playing field' after the proper charging against profits of the full economic rent of land. In other words, if all firms, not just those without freeholds or beneficial leases, paid a full economic rent, then they would be left in a truly comparable situation as regards economic efficiency and the ability to make profits, properly defined as a return to entrepreneurs. Moreover, the extent to which monopoly power of varying degrees relies on ownership of land would become evident if economic rent were shown explicitly in the analysis of monopolistic competition, monopoly and, perhaps most interestingly, oligopoly. The tendency towards oligopoly in many key industries, such as oil and retailing, in the UK and other advanced economies could then be seen as not so much a financial and technological phenomenon, but rather one founded largely on unconditional land ownership.

Part Three on factor incomes begins with the law of rent itself (Chapter 8). The classic statements of this, of course, were in Ricardo, John Stuart Mill, Alfred Marshall and, with less orthodoxy, in Henry George. In the twentieth century it was largely ignored, except as a very minor and isolated part of micro-analysis. Why this happened is a matter for historians of ideas and sociologists. Vested interests in land have undoubtedly played a part, particularly since the widespread movement of Georgists to introduce a land tax. Yet there can be little doubt about its relevance to the present day economy. Most obviously the housing market is almost dominating economic policy, through the need to adjust interest rates to control housing demand. What is rarely noticed is that it is the land element in house prices that causes the problem, not the price of 'bricks and mortar' (see Chapter 19 on Housing).

There is, however, an intellectual reason why the law of rent has been downgraded. This is the outright mistake in analysis perpetuated by generations of textbook writers, which identifies it with 'rent' defined as the excess of earnings of a factor over its transfer earnings (Chapter 9). Economic rent of land is the difference between the potential output from a particular site and the potential output using the same inputs on the least productive site in use i.e. the marginal one. This is totally distinct from any excess over transfer earnings; in the case of land, transfer earnings from a change of use. Economic rent takes the use to be the same in calculating the excess output on the superior site. Neither concept of rent is wrong. The problem is that they are confused, with the result that the economic rent of land is grossly underestimated in its scale and impact on the economy.

Wages are dealt with within this context (Chapter 10). Thus the general level of wages is determined by what happens at the margin of production. This is not the margin as used in marginal productivity theory, but the margin as defined by the law of rent. This means that wages are in general set by what labour can produce on the least productive sites in use. Of course, actual wages vary a great deal around this norm, owing to both equilibrium and disequilibrium differentials. Such a generalisation, which no doubt could be studied empirically at much greater length, exemplifies the natural law approach, for it is a consequence of the law of rent. Production on the margin sets an absolute upper limit to wages, though these may be reduced further by charges on marginal firms, such as a landlord's claim or taxation.

The analysis of capital that follows is, no doubt, even more controversial, since it argues that only in a diminished sense is there such a

thing as 'capitalism' (Chapter 11). This turns upon the point that capital only receives its supply price i.e. cost of production. Any apparent return above this is either a short term quasi-rent, or is a result of monopoly power of some kind. What is commonly regarded as capital is, in fact, money loans. Economists make the distinction between capital goods and financial capital, and then often follow the layman's practice of identifying the two. In this book they are kept strictly distinct. Financial capital is consistently treated as money loans, which usually receive interest. Hence Chapters 11 and 13 should be read as a continuous argument. The question of profits, however, intervenes (Chapter 12). Here the analysis originating with Schumpeter is used, with his brilliant account of the role of the entrepreneur as the creative element in a free economy.

Part Four deals with the complex issues of money and value. Credit is seen as the natural feature of society that underlies the use of money, on the grounds that money itself is no more than a principal form of credit, enhanced by the trustworthiness of bankers and central governments (Chapter 13). The radical aspect of this discussion, however, lies more in the analysis of interest. Historical theories, such as those of Bohm-Bawerk and Marshall are briefly considered, but the conclusion reached – that banks could provide credit in the form of advances at the supply price of money i.e. at an almost zero interest rate – is based on argument. A key point is that there is a vital distinction between money created by banks giving advances on one hand, and money lent by money lenders to borrowers on the other. The latter may well need to be charged at interest, depending on the supply and demand for funds, but the former need not charge interest above the supply price, which is the cost of a banking service. Needless to say, were banks to follow this practice, the market for loanable funds would move hugely in favour of borrowers. In which case Keynes' famous 'euthanasia of the rentier' might be a practical possibility!

Value is demarcated from price, by defining the latter as whatever is given, or promised, in a transaction, whilst the former is an entirely subjective concept (Chapter 14). Nevertheless it is shown that value can be given an ordinal, but not a cardinal, measurement. The result is that value so measured can be directly related to supply and demand analysis. This is important for the consistency of the book, since the revised theory of the firm retains a faith in supply and demand curves!

Part Five, entitled Public Revenue, is admittedly somewhat of a ragbag collection of topics, united by the single, overriding idea of rent of land as public revenue. Present day taxation is analysed in terms of

the primary division of output between rent and wages (Chapter 15). This yields a rather different view of the impact of both direct and indirect taxes from that conventionally given. The main reason for this is that the impact is viewed essentially as occurring on the margin of production. Thus taxation which is levied on the margin closes down firms and creates unemployment, whilst taxation proportional to the rent of land has a nil impact on the margin. This is one major rationale for collecting rent as tax. The other is based upon the proposition that factors of production in an efficient economy receive income pro rata with their ability to create it. Landowners create no income – except in so far as they manage land – whereas society creates economic rent by its activity and infrastructure. Hence it is the community, not landowners, which attracts rent in an efficient economy.

A very brief historical analysis is introduced to give a fresh slant on how the UK economy has developed since the main period of land enclosure (Chapter 16). This is not at all intended to recommend a return to a pre-enclosure past. Rather it is to emphasise that the current payment of rent of land into private hands distorts economic efficiency and denies the Exchequer what should be its principal source of revenue. Chapter 17 on Externalities is an attempt to show how the greatest measure of externalities is – guess what! – rent of land. A landowner receives rent as a result of all the external benefits created by surrounding firms, public infrastructure and other economic activity. Similarly landowners may suffer, to a lesser extent, from negative externalities, such as pollution. Rent is a precise measure of both types of externality. A notable example of this is the huge increase in land prices when a railway is built, as in the case of the Stratford extension of the London Underground, or the new London Crossrail. Some observers have been shrewd enough to see this and call for the introduction of a land tax to recoup these externalities. But why should this not be a general conclusion, rather than one related only to particular projects?

Chapter 18 on Natural Monopoly, like that on the theory of the firm, seeks to make explicit the rent of land element in most natural monopolies. This has been largely ignored in debates over privatisation, even though the commercial interests involved have often been quick to draw appropriate conclusions about the land values obtainable from privatised utilities, like rail and public buildings. The monopoly aspect of utilities is usually intimately tied to ownership of land, simply because they naturally use large and valuable sites. Were the rent of these charged in their accounts, their real viability as public or private

enterprises would be revealed. Moreover, such utilities create particularly large external economies. Transport systems, for example, raise land values enormously, yet only receive revenue from transport users as passengers. Their fixed costs, at least, could easily be financed out of a land tax, which would merely represent the uncollected value that they create.

Housing as a topic sits uneasily under the heading of Public Revenue (Chapter 19). The justification for its position is that house prices are very easily divisible into building costs and land prices. Since the latter are the capital value of annual rent, housing could be a suitable subject for a land tax in substitution for existing rates. This distinction goes some way to explain the present housing crisis in the UK, whereby accelerating house prices lead to a generation gap between older house owners and young people unable to afford homes. Building costs are subject to a relatively free market in materials, labour etc. Land costs are determined by a fairly fixed supply of suitable land, rising demand and competition with other land uses, especially in urban areas. Were rent collected as public revenue, the land element in 'house' prices would diminish. (Chapter 27 deals with problems of adjustment.)

Part Six begins with a straightforward 'textbook' account of the theory of income determination, in the expectation that this is less familiar to some readers than other areas of economic analysis (Chapter 20). It is followed by three chapters (21-23) which form a critique of the whole theory. These apply the preceding concepts of rent, money and credit, and taxation to the assumptions and deductions of the theory, concluding with a reformulation. Chapter 24 'The Model Reformed' shows that the existing theory has implied limitations, which if withdrawn reveal an economy with greatly enhanced productivity, efficiency and fairness. The limitations are restrictions on the use of land, restraints on the availability of credit, especially for productive investment, and the destructive impact of taxation on labour and enterprise. The reform of the theory reveals the possibility of a reformed economy, in which wages are determined by the full product of marginal land, rent of land becomes entirely public revenue, and secondary claims on output, such as interest, taxation on labour and enterprise, and monopoly profits have disappeared. Such a reformed economy is, of course, an ideal. But economic thought is sadly in need of a new ideal. Socialism has long ceased to be one. So-called free market economics is proving itself a poor substitute, even if some of its tenets are well-founded. Why not then consider free

men and free land as a new vision to be attained? We in Britain have some conception of what it is for people to be free, but historically we have little idea of what free land means. The subtext of this book is a definition of free land, meaning land free for the whole of society and not for a minority.

How a reformed economy would behave in an international context is briefly considered in Chapter 25. Much more needs to be said about this. As always confidence would play a large part, but confidence is itself mainly attributable to the type of economy in which one lives. Chapter 26 takes a brief look at business cycles. It does not quarrel greatly with the existing method of treating them as functions of variables, such as the levels of consumption and saving, investment, government expenditure and the trade balance. Predictably, however, it emphasises the role of land in their generation. The existence of a market in land, and especially the creation of bank advances for the purchase of land, are seen as adding to the virulence of cycles, which otherwise could be accommodated more easily by price and wage changes. Needless to say the reformed economy would adapt itself to cycles by a much greater flexibility upwards and downwards of prices and wages.

Finally, the concluding Part Seven deals first with some practical problems that would arise were the principle of collecting rent of land as public revenue carried out (Chapter 27). These are partly transitional problems, partly problems associated with radically changing existing rights. Harold MacMillan once wisely said that there is never any real reform without a change in property rights. There can be little doubt that the great majority of people would benefit from the reform of land law in the UK. Existing rights of tenure could be maintained, even strengthened. Perhaps existing inheritance rights could remain unaltered. The key reform is, of course, the transference of rights to economic rent from private landowners to public authorities, be they central and/or local. Yet even those landowners who surrendered the right to rent might, in the course to time, come to appreciate the general rise in physical and moral well-being of the community in which they live, and to find their own place in it as productive and enterprising individuals, as some have already.

Plato is quoted near the beginning of this book. His great theme of justice in the *Republic* returns to complete it (Chapter 28). Nowadays Economics is rarely studied in relation to justice. If this book contributes even slightly to a closer connection between them in the minds of readers then it has well satisfied the purposes of the author.