

Kimpton, Sean

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**The Nature and Causes of Profits: The Classical Approach from  
Smith to Marx**

Sean Kimpton

2014/07

# The Nature and Causes of Profits: The Classical Approach from Smith to Marx

Sean Kimpton

Auckland University of Technology

## Abstract

*The Global Financial Crises has motivated some to rethink the dominance of global capitalism. This has revived an interest in Marxist doctrine and in particular its examination of the notion of exploitation. Marx's theory of value is central to his examination of exploitation. This paper will show that both these posits of Marx are in error. Further, it will show that Marx draws heavily on Smith's idea of the primacy of wages. However, this paper will demonstrate that profit, and not wages, are the original source of income. This paper reaffirms the importance of profits and the ability of entrepreneurs and capitalists to pursue them.*

**Keywords:** Adam Smith; Karl Marx; Profit; Exploitation; Labour Theory of Value; Classical Economics;

## **1. Introduction**

Marxian exploitation theory remains one of the most influential economic doctrines in the world today.<sup>1</sup> While global communism has collapsed the assumptions that underpin such a system are still prevalent. It remains the most forceful attack on the argument made in this paper, that entrepreneurs are the source of productive initiative. The Global Financial Crises has led some to again question capitalism and look for an alternative approach in the Marxist doctrine. This paper will, then, explore Marx's influence, concentrating on his core attacks against capitalism and free markets. This will entail an exploration of his theory of exploitation which rests heavily on his labour theory of value. This paper will critique both the labour theory of value and the theory of exploitation posited by Marx and the analytical Marxists. Bohm-Bawerk provides a substantial attack on the Marxist position, yet this attack does not drive to the core of the matter. Marx proceeds, following Adam Smith, that wages are the original source of income. This paper contends that this is an error. Instead, it is posited that profits are the primary income. It is this development that ultimately causes the Marxist doctrine to wither. This paper reaffirms the importance of profits and the ability of entrepreneurs and capitalists to pursue them.

## **2. The Influence of the Exploitation theory**

Marxian exploitation theory asserts that all income (i.e. productive enterprise) naturally comes from wages and therefore belongs to the wage earner. Under capitalism it is alleged that wage earners receive less than the value they create. While workers create all the value with their efforts they do not receive the full asking price for a given good. The difference represents a surplus-value extracted by the capitalist. That is, the entrepreneur has taken value from the workers that he has no legitimate claim too.

Ultimately, capitalism is, according to the exploitation theory, a system of virtual slavery for the benefit of a few exploiters, namely the entrepreneurs and capitalists, at the great expense of the masses. This remains the essential view of a great many intellectuals and a large proportion of the general population. The consistent and massive increase in the standard of living since the industrial revolution in capitalist countries has done little to discount the

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<sup>1</sup> Alan Ryan, for example contends that "Marx and Mill and their successors are our contemporaries, and can be argued with as such." *Property and Political Theory*, (Oxford: Basil Blackwell, 1984), p.142. See also Reisman *Capitalism*, (Ottawa, ILL.:Jameson Books: 1990) pp.603-604.

influence of this doctrine.<sup>2</sup> Rather, increases in the standard of living are often attributed to the infringements upon *laissez-faire* capitalism. Capitalism, it is conceded, may be the most productive economic system going, but that it needs to be reigned in with regulation, so that it can be made to benefit everyone and not some small elite. Thus, it is to labour unions, social legislation and even some new “enlightened” personal ethic on the part of entrepreneurs that people credit much of our economic progress. Indeed, it is considered unconscionable to even suggest the abolition of minimum wage laws, maximum-hours legislation and the prohibition against child labour. A society without such regulations would, it is feared, allow the businessman to pursue their narrow self-interest without restraint, resulting in wage rates plummeting to that of subsistence, the hours of work would steadily increase until it reached the upper limit of what humans can bear, and children would soon be working in factories. These concerns are exactly what Marx alleges will happen under his exploitation theory.

The Marxian exploitation theory, then, continues to be an intellectual influence on not only the numerous communist and socialist organisations around the world, but also on a great number of individuals that would not consider themselves to be communist or socialist. While the exploitation theory is a poor description of present economic conditions, it is held as a true account of capitalism unfettered by government regulation of the economic system, the unrestrained capitalism of the nineteenth century. It is a commonly made assertion that the economic conditions of the nineteenth century, essentially caused by capitalist greed, were deplorable for all but the very rich.<sup>3</sup> Thus, it is further postulated, that improvements in those economic conditions must largely be attributable to government regulation that restrain the avarice of capitalist class.

It is on this basis, the assumed correctness of the Marxian exploitation theory, that the welfare state or mixed economy emerges. The economic policies of the advocates of social democracy are simply a practical application of the exploitation theory to *laissez-faire* capitalism. Such economic policies not only require the intervention into the labour market (as pointed out above), but a progressive income tax (including an inheritance tax), social welfare spending,

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<sup>2</sup> Deirdre McCloskey, "The Industrial Revolution: A Survey," a new essay, in Floud and McCloskey, eds., *The Economic History of Britain, 1700-Present*, 2nd ed. (Cambridge; 1994).

<sup>3</sup> For an alternative history of the nineteenth century see, for example; Ludwig von Mises, *Human Action; A Treatise on Economics*, (Auburn; The Ludwig von Mises Institute; 1998), pp.613-619; Robert Hessen, 'The Effects of the Industrial Revolution on Women and Children' in *Capitalism: The Unknown Ideal*, (Signet, 1967); F.A. Hayek, *Capitalism and the Historians*, (Chicago: University of Chicago Press, 1954).

state housing, and the provision of public health and education systems. These policies, it is considered, come only at the expense of the capitalist and represent no harm to the average wage-earner. These measures, it is believed, can be financed at the expense of entrepreneurial profits—from surplus value. The workers, then, should only see a boon of higher wages for less work performed and access to an array of public services, such as health care and public education. Essentially then, these economic policies are thought of as basically giving back to the working class a fraction of the wealth allegedly expropriated from them by the entrepreneurial capitalist.

Thus, the intellectual force of the Marxian exploitation theory is not to be found in the few remaining communist countries, but instead in Western Democracies. It is allegedly in the operation of the welfare state and mixed economies that we find the worker to be, at least partially, liberated, able to receive a greater fraction of the value that only he can create, achieved through the mechanism of the state. If the Marxian Exploitation theory stands, then this paper will have failed to prove the importance of entrepreneurial behaviour. Nothing less than a full rebuttal of this doctrine is required. But first, let us briefly deal with Marx's treatment of Human Rights, an essential aspect of this paper.

### **3. Marx on Rights**

Karl Marx argues that the moral space<sup>4</sup> rights grant an individual “is that of an isolated monad...withdrawn into himself.” He states that “the right of man to freedom is not based on the union of man with man, but on the separation of man from man. It is the right to this separation, the rights of the limited individual who is limited to himself.” Marx continues with a condemnation of the right to property as “the right to enjoy his possessions and dispose of same arbitrarily, without regard for other men, independently from society, the right of selfishness.”<sup>5</sup> But rights are not designed to separate “man from man”. They are designed to separate an individual from thieves and various forms of attacker, but very much allow the individual to engage with other individuals in mutually beneficial relationships. In providing protection to individuals within a society from those that would do them harm, rights provide the foundation for the exchange of mutually benefiting values within the societal context.

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<sup>4</sup> Robert Nozick, *Anarchy, State, and Utopia*, (New York: Basic Books 1974).

<sup>5</sup> Karl Marx, “On the Jewish Question,” in ‘*Nonsense Upon Stilts*’: *Bentham, Burke and Marx on the Rights of Man*, ed. Jeremy Waldron (London: Methuen, 1987), P.146.

#### 4. The Labour Theory of Value

The labour theory of value provides the foundation of the Marxian exploitation theory. Traditional Marxian theory stands and falls on the correctness of this doctrine.<sup>6</sup> Drawing on the classical economist's labour theory of value, notably Smith and Ricardo, yet ignoring many of their qualifications, Marx develops a more absolutist version of the labour theory of value.

Marx writes:

A use-value, or useful article, therefore, has value only because human labour in the abstract has been embodied or materialized in it. How, then, is the magnitude of this value to be measured? Plainly, by the quantity of the value creating substance, the labour, contained in the article. The quantity of labour, however, is measured by its duration, and labour-time in its turn finds its standard in weeks, days, and hours.<sup>7</sup>

Immediately we could object that Marx is implying that goods produced with relatively idle or less skilled workers would be more valuable than the same goods produced with more active or more skilled workers. But Marx anticipates our objection. He contends that he is writing of “socially necessary” labour-time: “The Labour-time that is socially necessary, is that required to produce an article under the normal conditions of production, and with the average degree of skill and intensity prevalent at the time.”<sup>8</sup> However, this response is unsatisfactory. The phenomenon being described by Marx is simply market competition. The fact that, in a particular market at a given time, equal quantities of the same good are sold for the same price, regardless of the varying amounts of labour contributed to produce them, is simply because of the operation of market competition. In the following paragraph, Marx immediately contradicts this notion of socially necessary labour-time:

Commodities, therefore, in which equal quantities of labour are embodied, or which can be produced in the same time, have the same value. The value of one commodity is to the value of any other, as the labour-time necessary for the production of the one is to that necessary for

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<sup>6</sup> David Gordon summarises it thus: “No labor theory, no surplus value; no surplus value, no exploitation; no exploitation, no fall of capitalism. *Resurrecting Marx: the analytical Marxists on exploitation, freedom, and justice*, (New Brunswick & London: Transaction, 1990), p.13.

<sup>7</sup> Karl Marx, *Capital*, trans from 3rd German ed. by Samuel Moore and Edward Aveling; Frederick Engels, ed; rev and amplified according to the 4<sup>th</sup> German ed. by Ernest Untermann (New York: Random House) p.45.

<sup>8</sup> Ibid. P.46.

the production of the other. “As values, all commodities are only definite masses of congealed labour-time.”<sup>9</sup>

Marx’s take on the labour theory of value is still confronted with the problem of skilled workers. The problem for Marx is that goods produced by a skilled worker in X amount of time are almost universally more valuable than those goods produced by unskilled labour in X time. This is in direct contradiction of the above postulate that the value of goods is simply a proportionate reflection of the amount of labour required to manufacture them. Marx deals with this issue with sleight of hand. He contends that: “Skilled labour counts only as simple labour intensified, or rather, as multiplied simple labour, a given quantity of skilled labour being considered equal to a greater quantity of simple labour...For simplicity’s sake we shall henceforth account every kind of labour to be unskilled, simple labour”.<sup>10</sup>

Thus the labour theory of value as propounded by Marx explains the exchange value of goods by their congealed labour content. Every product is assumed to contain the amount of labour that was required for its manufacture. The value of one good compared to another good (and to all goods), that is their mutual exchange ratio, is therefore, nothing more than the ratio of their respective congealed labour contents. Marx states that: “In this sense, every commodity is a symbol, since, in so far as it is value, it is only the material envelope of the human labour spent upon it.”<sup>11</sup> The price of all goods could thereby be set in comparison to a base commodity, say gold. If a gram of gold is worth \$10 then a good that sells for \$5 must have half the congealed labour time required to produce it than a single gram of gold.

Marx presents us with an absolutist version of the labour theory of value. One where all value is directly caused by labour and relative only to the proportion of congealed labour required to manufacture the commodity. This theory logically implies that any value added during the production stages must be due to the application of fresh labour. The value (i.e. labour) of the machines and materials used to produce the good are also contained in the produced good. For the good to be worth more than this already existing congealed labour, fresh labour-time must be added to create addition value. Thus, the sum of a firm’s profits with the wages it pays its workers is proportionate to the fresh labour added by that particular firm.

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<sup>9</sup> Ibid. Marx is quoting himself.

<sup>10</sup> Ibid, pp.51-52.

<sup>11</sup> Ibid, p.103.



The labour theory of value suffers from some critical faults. While classical economists, the tradition Marx is writing in, sought an intrinsic property that gave commodities their value, a more convincing economic theory of value places value not in the object, but in the mind of the valuer. Value is determined, not by the costs of production, but by the ability of the good to serve as a means for an individual's end. Mises states that: "Goods, commodities, and wealth and all the other notions of conduct are not elements of nature; they are elements of human meaning and conduct."<sup>12</sup> I may labour away intensively for long periods of time to produce finely crafted widgets. But without a willing buyer, that is someone that values my product, the congealed labour in the widgets has not created a valuable item. Marx could respond here by reminding us of his "socially necessary" criteria. Clearly, widgets, no matter how finally crafted are not socially necessary. But this objection is unconvincing. What, after all, would make my good socially necessary? Why, a buyer of course. Someone that is willing to buy my widgets to use as a means to achieve an ends. Therefore, it is not my congealed labour in my product that creates its value, but the subjective preferences of the valuer.<sup>13</sup>

Furthermore, we can question Marx's assumption that an exchange of goods involves an equality. Marx contends that if two pears can be exchange for two potatoes then one pear = one potato. He then examined why this is the case, ultimately arguing that these items must contain the same total amount of congealed labour-time. But Marx has moved too quickly. Why assume that there is any such equality? Indeed, it seems more plausible to suggest that there is, in fact, a double inequality.<sup>14</sup> The person with the pear will not trade the pear for the potato unless they value the potato more than the pear; likewise the individual with the potato will not give it up, unless he values the pear greater than the potato. The existence of these two inequalities are sufficient to explain economic value. An intrinsic theory of value is not required, as there is no equality to start with.<sup>15</sup>

Additionally, Marx's proposition that only fresh labour can create value at each stage of production is highly dubious. Indeed, according to Marxist theory of labour, a fully automated

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<sup>12</sup> Mises, p.92.

<sup>13</sup> For more on the Austrian Economic Theory of Value see Mises chapter IV and Carl Menger, *Principles of Economics*, (Auburn: Ludwig von Mises Institute, 2007).

<sup>14</sup> Murray Rothbard, *Man, Economy, and State*, Ch.I. Vol. 2. (Princeton, NJ: D. van Nostrand, 1962).

<sup>15</sup> Robert Nozick objects to this "double inequality" proposition. He argues that if a pear can be secured with a potato (and vice versa), barring transaction costs, then practically speaking, we have an equality. See *Anarchy State and Utopia*, pp.64-65. But unlike Marx, he does not contend that this is because of some underlying property (namely labour for Marx). That is, Nozick does not suggest that the exchange ratio is an identity along the lines of 1 labour hour = 1pear = 1potato = 1 labour hour. So our criticism of the labour theory stands.

manufacturing plant, requiring the addition of next to zero fresh labour to transform raw materials into a commodity, the value of that commodity could not exceed the value of the raw materials and any depreciation on the plants machinery. But this is unlikely to be the case. Presumably, the final product would be better at meeting people's means/ends requirements than the raw material alone and therefore should be more valuable. For example, fully automated parking lots are clearly more profitable than manned ones, yet receive far less fresh labour. The labour theory of value also fails to explain the value of land and livestock used in farming, neither of which are produced by human labour. Nor does it explain why aged wine, whiskey or cheese are more valuable than newer wine, whiskey or cheese, even though no additional labour is applied in the aging process.

### **5. Exploitation theory**

The Marxian exploitation doctrine is seriously undermined by the critical faults with the absolutist labour theory of value. A theory of exploitation resting on the labour theory of value simply fails to get off the ground. However, our task is not done. The “analytical Marxists” argue that the Marxian exploitation doctrine can survive the rejection of the labour theory of value. The members of this subset of Marxists—who include G.A. Cohen, Jon Elster, and John Roemer—contend that the labour theory of value is indeed outmoded. Elster sums up the analytical school's view of the labour theory of value when he writes: “I argue that the theory is useless at best, harmful and misleading at its not infrequent worst.”<sup>16</sup> However, they maintain that the main thrust of the Marxian exploitation doctrine is correct. Roemer, for example, claims that Marxian exploitation doctrine can be conceptually separated from the labour theory of value. He contends that a “generalized commodity exploitation theory” can be established and validated without reference to the labour theory of value.<sup>17</sup> Cohen, on the other hand, advances the notion that workers are “collectively unfree” in the sense that they are unable to escape the proletariat. While workers are not forced to work for any one capitalist, the “economic structural constraint” gives the worker no other choice but to work for a capitalist.<sup>18</sup> Here then, I wish to present the Marxian Exploitation doctrine in its essentials, absolving its advocates of the need to validate the labour theory of value.

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<sup>16</sup> Jon Elster, *Making Sense of Marx*, (Cambridge University Press, 1985) p.120.

<sup>17</sup> See John Roemer, *A General Theory of Exploitation and Class*, (Cambridge, Mass.:Harvard University Press, 1982); idem, *Value, Exploitation and Class*, (London: Harwood Academic Publishers, 1985).

<sup>18</sup> G.A. Cohen, ‘The Structure of Proletarian Unfreedom,’ ed. John Roemer, *Analytical Marxism*, (Cambridge: Cambridge university Press, 1986), pp. 237-59.

Marx begins his exploitation analysis with the pre-capitalist social systems, namely, slavery and feudalism. He contends that these are social systems that are fundamentally exploitative. It is not difficult for a liberal thinker to agree with this characterisation. The interests of the slave are simply not aligned with that of the slave owner. The slave, unfree to pursue their interests, does not benefit from his enslavement. Enslavement, instead, attacks the slave's very ability to flourish as a human qua human, while increasing the income of the slave owner. It is a relationship based on coercion, with one side benefiting at the others forced expense. Feudalism also presents an antagonistic relationship. The feudal lord extracts land rent from the peasants that work the land. While there is nothing wrong with legitimate owners renting parcels of land, it is difficult to consider feudal lords as such. Their ownership is based on force of arms and not on any value they may have created over the land. Instead, it is the peasants that have created the value by homesteading the land. The feudal lord's gains come at the expense of the peasants. It is hardly surprising then that slavery and feudalism hamper productive development.

More controversial is Marx's idea that such exploitation, as described above, continues under capitalism. Under capitalism the slave becomes a free labourer able to produce in his own interest and landownership becomes increasing characterised by those that homestead it, legitimatising land rent. However, Marxism maintains that capitalism is still an exploitive social system. Indeed, Marx is quick to point out that the historical emergence of capitalism is based on an initial accumulation of property, of which a significant amount was formed through conquest or other nefarious means.<sup>19</sup> Similarly he looks at the use of coercion associated with colonialism and its spreading of capitalism around the world.<sup>20</sup> Marx is rather successful in conveying that some acts performed under early capitalism could easily and appropriately be labelled as exploitative. However, such historical investigation only serves to arouse our indignation at the injustice that originated a number of the early capitalist fortunes. It distracts us from the core Marxist thesis being advanced: namely that capitalism, even if it was to emerge as a social system without the historical injustices it would still be an essentially exploitive system. Capitalism based on nothing more than the accumulation of capital via the hard work and savings of capitalists would still be exploitive the moment the capitalist employed a free labourer.

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<sup>19</sup> Marx, *Capital*, Ch.24 "The So-called Original Accumulation".

<sup>20</sup> Ibid, Chap.25 "Modern Theory of Colonialism".

How is it then, that such untainted capitalism could be characterised as exploitive? The basic idea is that the capitalist extracts surplus value from the workers they hire. It is observed that the wages paid to the workers are lower than the final sale price. The employee works for five days yet his remuneration, the money wages he is paid, can only purchase consumption goods produced over three days. Given that the remuneration he receives is less in terms of consumption goods he himself has produced, he has been exploited. The capitalist has expropriated two days of the labourer's efforts for himself. The capitalist has gained at the expense of the worker.<sup>21</sup>

Let us consider a more complex elaboration of Marx's doctrine. Consider a workshop containing \$50 worth of tools, machinery and inputs. The owner of the workshop will hire 10 hours of labour to produce a final product, which he will then sell for \$60. The ten hours of effort exerted by the hired workers represent the difference in value between the materials contained in the workshop and the final product. This difference in value is therefore the sum of wages and profits. The division of what part of the value added is profit and what part is wages is governed by the price of labour. If the 10 fresh labour hours can be purchased from the worker for an amount able to purchase basic necessities which would only require five hours to produce, then the worker is paid \$5. Thus the workshop owner purchases 10 hours of labour and the value created by the addition of that fresh 10 hours, but only pays a price commensurate with only five hours. Thus profits under the capitalist social system are achieved by the chronic under-remuneration of labour. The owner of capital purchases a full days labour, but expends only for the hours necessary to produce the employee's basic consumption goods. The hours the labourer contributes to the capitalist above this amount are essentially unpaid—an expropriation of surplus value by the owner at the expense of the worker. Exploitation under capitalism, then, can be expressed as profits relative to wages.<sup>22</sup>

It is clear from the above examination that when Marx declares that: "The History of mankind is the history of class struggles"<sup>23</sup> he is absolutely serious. Under the Marxist view wage earners are the modern day counterpart to the slave or serf of previous social systems, while today's entrepreneurs and capitalists are the counterpart of slave masters and feudal lords of those pre-capitalist societies. The Marxian concept of surplus value attributes the creation of

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<sup>21</sup> See Ibid vol. 1; For a shorter presentation of this concept see Marx's *Lohn, Preis, Profit* (1865).

<sup>22</sup> For Marx's own example and further elaboration on the rate of exploitation see Ibid, vol. 1 pp.658-659.

<sup>23</sup> Marx, and Engels, *The Communist Manifesto*, section 1.

profit, and any other non-wage income for that matter, to the same cause that allows the slave owner to benefit from slavery. The slave owner gains from the slave's ability to produce more than his basic requirements to sustain himself. The excess produced by the slave over and above this amount goes to benefit the slave owner. This is exactly how the surplus value concept suggests capitalists gain profit.

The Marxian exploitation doctrine also suggests that the benefits of economic progress will not be enjoyed by wage earners. Economic progress means the introduction of new and better goods and reductions in the price of current goods. However, the exploitation doctrine suggests that workers will not see these benefits, because any reduction in the price of goods purchased by the workers will be met with a corresponding reduction in their wages. Ultimately this will amount to an increase in the proportion of the wage earners labour hours expropriated by the wage payer for surplus value. Here is Marx's own example:

The value of commodities is in inverse ratio to the productiveness of labour. And so, too, is the value of labour-power, because it depends on the value of labour-power, because it depends on the value of commodities...[S]urplus-value is, on the contrary, directly proportional to that productiveness. It rises with rising and falls with falling productiveness. The value of money being assumed to be constant, an average social working day of 12 hours always produces the same new value, six shillings, no matter how this sum may be apportioned between surplus value and wages. But if, in consequence of increased productiveness, the value of the necessaries of life fall, and the value of a day's labour be thereby reduced from five shillings to three, the surplus-value increases from one shilling to three. Ten hours were necessary for the reproduction of the value of the labour-power; now only six are required. Four hours have been set free, and can be annexed to the domain of surplus labour. Hence there is an immanent in capital an inclination and constant tendency, to heighten the productiveness of labour, in order to cheapen commodities, and by such cheapening to cheapen the labourer himself.<sup>24</sup>

Economic progress then, according to Marx, is only for the benefit of the capitalist class, it operates only to the benefit of the exploiters. The workers are unable to purchase any more

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<sup>24</sup> Marx, *Capital*, vol. 1, pt. 4, chap. 12, pp.350-351.

goods than they did previously. They are unable to purchase an increased amount of the goods they currently purchase, nor are they able to take advantage of the newer goods now being produced without consuming less of their original set of goods. But not only does the exploitation doctrine suggest economic stagnation for wage earners, it predicts economic impoverishment. The lot of labourers will become increasingly difficult with a steady slide in their standard of living. Marx states that: “The modern labourer...instead of rising with the progress of industry, sinks deeper and deeper below the conditions of the existence of his own class. He becomes a pauper and pauperism develops more rapidly than population and wealth.”<sup>25</sup>

Marx presents a withering attack on the capitalist society. However, the Marxian exploitation doctrine, free of its reliance on the labour theory of value, is not immune to critique. It is criticism of the Marxian conception of exploitation I would now like to turn.

## **6. Bohm-Bawerk’s Critic of the Marxian Exploitation Doctrine**

Bohm-Bawerk is perhaps the most influential critic of the Marxian exploitation doctrine. He argues that profits are, in fact, a legitimate deduction from the wages of workers. He points out that entrepreneurs pay their labours in advance of any sale of the goods produced by the labourers. Given that this payment is in advance of any final sale of the product, the operation of time preference becomes relevant. As we prefer present goods to future goods workers will be willing to receive less now over the promise of slightly more in the future. With the introduction of the concept of time preference then, we see that, according to Bohm-Bawerk, present wages simply represent discounted present value of the worker’s future good. When the entrepreneur sells the final good, the difference between the final price and the wages paid represents a justified profit.

Bohm-Bawerk ‘s best illustration of his argument is his famous engine example, where five cooperative workers take five years to build an engine from scratch, doing everything from producing the tools required to get the ore out of the ground to final assembly of components that make up the engine. It is then assumed by Bohm-Bawerk that the final engine will sell for \$5,500 and that the five workers each perform the same amount of labour. That is, each worker provides with their labour the exact same quantity of time (one year) and skill. The only

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<sup>25</sup> Marx, and Engels, *The Communist Manifesto*, Chap. 1, pp.37-38.

difference between the workers is that they each complete a different stage of the production. So the first worker must ultimately wait four years after the completion of their years efforts before he is finally remunerated, while the fifth worker in the sequence will be paid immediately on completion of the engine, while the other workers wait three, two and one year respectively.

These unequal waiting times, Bohm-Bawerk points out, will encourage the cooperative to make unequal division of the engine's final sale price. The worker that completes the first stage of production and therefore must wait the longest will receive the greatest proportion of the engines value, more than the one-fifth of the final sale price that his equal labour would normally entitle him. Rather than receiving \$1,100, Bohm-Bawerk suggests that the first worker will receive \$1,200. This line of logic suggests that the fifth worker who is paid on completion of the final product will receive less than one-fifth of the final sale price, only \$1000. The other three workers will, of course, receive various amounts between these two limits.<sup>26</sup>

Thus, because present goods are subjectively worth more than future goods of the same type and quantity, the workers themselves would voluntarily make such an unequal division of the engine's sale price. Simply put, \$1,100 received upon completion of one's efforts is more valuable than the same sum after one to four years worth of waiting. An equal distribution of the value of the engine to the workers would mean that those workers that worked earlier on the engine construction and thus endured longer waiting times would actually receive subjectively smaller value than those workers that completed their efforts later, who had to undergo little or no waiting time at all. As such, Bohm-Bawerk argues, a \$1,200 distribution four years after the completion of one's efforts is simply the equivalent of a \$1000 distribution without any waiting time after the completion of the work.<sup>27</sup>

It is at this point that Bohm-Bawerk introduces a capitalist/entrepreneur. The entrepreneur is able to pay the workers immediately on the completion of their work. Now all five workers are in the position of the final worker, who by their own voluntary agreement would have only

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<sup>26</sup> Cf. Eugen von Bohm-Bawerk, *Capital and Interest*, 3 vols., trans. George D. Huncke and Hans F. Sennholz (South Holland, ILL.: Libertarian Press, 1959, 1:263-271.

<sup>27</sup> *Ibid.*, 1:266.

received \$1,000. As such, the just payment to each of the five workers is \$1000 each, because no worker now has to endure any waiting times between the completion of their work and the receiving of payment.<sup>28</sup>

Thus, according to Bohm-Bawerk, profits are, in fact, a just deduction from what would otherwise legitimately all belong to the workers. The entrepreneur remunerates the first worker immediately on the completion of the first year's work the sum of \$1000, which is the net present value of \$1,200 that the worker would otherwise have received in four years. The second worker is also paid \$1000 by the entrepreneur at the end of the second year, which represents the present equivalent of the \$1,150 the worker would have received after three years of waiting. And so on and so forth. The entrepreneur then, pays to the first four workers the present discounted value of their expected return on the final sale of the future engine and assumes the role of waiting. When the engine finally ceases to be an expected future good and becomes an actual present product, the entrepreneur then sells the engine at its full, undiscounted, present value. That is, the entrepreneur purchases the right to a prospective future good, an engine ultimately worth \$5,500, by purchasing the labour to produce the good at its present discounted rate of \$5,000. By taking over the waiting aspect of the production process the entrepreneur is able to make a \$500 profit.

This analysis suggests a serious flaw in the Marxian exploitation theory, namely that he does not appreciate the operation of time preference as an essential part of human action.<sup>29</sup> That the wage-earners do not receive the full final sale price for an item is not because of any exploitation but simply a reflection that it is impossible to exchange future goods for present goods except at a discount. Rather than the existence of a master/slave relationship, as Marx suggests, the concept of time preference reveals a fundamentally harmonious arrangement. The wage-earner and the entrepreneur enter into such arrangements voluntarily because they have opposite time preferences. The labourer enters the arrangement because, given his time preference, he prefers fewer present goods to more future goods; the entrepreneur enters because he has the opposite time preference, preferring more future goods to fewer today. Without the entrepreneurs opportunity for profit the wage-earner would be worse off having to

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<sup>28</sup> Ibid., 1:269.

<sup>29</sup> For accounts of the time preference theory of interest see Frank Fetter, *Capital, Interest and Rent*, (Kansas City: Sheed Andrews and McMeel, 1997; see also Ludwig von Mises, *Human Action*, (1998).



wait extended periods of time for the goods he wants; without the worker's preference for present goods the entrepreneur would be worse off also, forced to resort to less roundabout and less efficient production methods than could otherwise be adopted.<sup>30</sup> The concept of time preference helps to reveal a mutual advantageous exchange and seriously brings into question the notion of exploitation by employers over workers.

However, as ingenious as these insights are, Bohm-Bawerk's analysis of the Marxian exploitation theory does not go far enough. He makes unwarranted concessions to the Marxian analysis. He accepts as valid the premise that the wage-earners are the creators of value with profits simply being a deduction from what is originally totally the income of the workers. Indeed, it is difficult to see how Bohm-Bawerk's cooperative could even be formed in the absence of capital to sustain the workers over the period of production. Assuming that the workers do have the capital to sustain such an exercise, and therefore able to engage in their share of the work with requisite tools then we have not wage earners but five entrepreneurs seeking profit. Wage-earning is not the primary source of income then, but profit. Let us examine this in greater detail.

## **7. A Theory of Profits**

As mentioned earlier, Marxian exploitation theory is the main source of denial of the productive role of entrepreneurs and their profit seeking. The essential claim, accepted by even some of its leading critics, such as Bohm-Bawerk, is that income is generated by and legitimately belongs to wage earners and that the capitalist economic system of profits, rent and interest represent the expropriation of surplus value from the wage earners to the capitalist/entrepreneur. It is this mistaken assumption that I seek to address here.

The originator of this error is, in fact, Adam Smith. Smith begins his chapter on wages with the following:

The produce of labour constitutes the natural recompence 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.

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<sup>30</sup> Hans-Hermann Hoppe, pp.122-123.

Had this state continued, the wages of labour would have augmented with all those improvements in its productive powers, to which the division of labour gives occasion.

He continues in a later passage:

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 recompence of 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 labourer 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 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 production 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.<sup>31</sup>

Smith advances two views in the above passages. Firstly, Smith is very disparaging of the private ownership of land and even suggests that there is no relationship between the entrepreneur and the division of labour system and its increase in the productivity of labour. The second view is the primacy-of-wages doctrine.

The thrust of Smith's argument is that entrepreneurial, capitalist and landowning activity has only the effect of denying wage earners the whole of their produce or its full worth. He seems

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<sup>31</sup> Adam Smith, *The Wealth of Nations*, bk. 1, chap. 5 [1:35].

to have overlooked or perhaps was simply unaware of the ways in which the division of labour is dependent of entrepreneurial activity. Indeed, it is the entrepreneur that fosters, develops and creates the ever improving division of labour. It is the entrepreneur that rearranges the factors of production to create more efficient and more roundabout production techniques. That is, techniques that require further and further specialisation of labour.<sup>32</sup> Smith also fails to see the important role that the institution of private property has in contributing to the division of labour system. Indeed, he saves some of his harshest criticism for the landowner:

As soon as the land of any country has all become private property, the landlords, like all other men, love to reap where they have never sowed, and demand a rent even for its natural produce. The wood of the forest, the grass of the field, and all natural fruits of the earth, which, when land was held in common, cost the labourer only the trouble of gathering them, come, even to him, to have an additional price fixed upon them. He must then pay for the license to gather them; and must give up to the landlord a portion, or what his labour either collects or produces.<sup>33</sup>

The security and associated incentives that private property give, lead to incalculable improvements on the land over its natural state. It is private property that leads to increased efficiency of production in both agriculture and mineral extraction. The landowner does not simply fence of a plot of land and live of the natural proceeds. Rather, they actively improve the productive ability of the land. Indeed, without this security of private property and subsequent improvement in the efficiency of agriculture and mining there simply would not be sufficient workers left over from agricultural production to form a true division of labour economy. That is, it is the freed up labour hours of workers that see the true development of division of labour in the areas of industry and commerce. Land left in its natural state will simply not allow for a division of labour as most of the workers will be required for food collection.

Smith's error here is perhaps understandable. In his time it would be easy to equate private property ownership with that of the privileged British landed aristocracy of his day. The aristocracy did enjoy a virtual sinecure through such means as protective tariffs and entail legislation.<sup>34</sup> However, this is vastly different from a system of genuine private property that

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<sup>32</sup> For more on this, see George Reisman, *Capitalism*, (Ottawa. ILL.:Jameson Books: 1990) pp.462-463.

<sup>33</sup> Smith, chap. 6 [1:56].

<sup>34</sup> Reisman, p.477.

subjects private landowners to the full force of competition. It is otherwise odd, even naive, that Smith didn't appreciate the improvements in land productivity from private ownership over the small charges for some items that had previously been free.

The second notion advanced by Smith that I wish to address is the primacy-of-wages-doctrine. This is the idea that in a pre-capitalist society—the “early and rude state of society”—the individuals of the economy simply produce and sell goods. They do not buy commodities in order to sell and the incomes of all the workers are wages. Wages then, in the view of Smith, are the natural or original income. All income in this “original state” is alleged to be wages, and not profit, because labourers are the only recipients of income. As we have already seen, Smith also advances the notion that profit, therefore, is simply a deduction from what is originally and legitimately wages.

This primacy-of-wages doctrine and the idea that profits and any other nonwage incomes are deductions from what is originally and legitimately wages is the fundamental framework that the Marxian exploitation theory is based on. They are the launch pad for Marx's careful development of the exploitation theory.

The pre-capitalist economy is characterised, argues Marx, by the following production sequence C-M-C. That is, in this “original state” a labourer produces a good C, which he in turn sells for money M, which then allows him to buy other goods C. This early economic arrangement is without exploitation, because there are no profits (or indeed any other nonwage incomes), no “surplus value” transferred from the rightfully owner to another. Only the establishment of capitalism, Marx postulates, creates surplus value and profit. Here the production sequence is M-C-M'. Here production begins with the capitalist or entrepreneur outlaying a sum of money M for the purchase of machinery, materials and labour hours. The result is the production of good C which is then sold for a larger sum of money M' than was originally expended to create the good. The difference between M, the money outlaid, and M', the money received for C, is the surplus value or profit made by the businessman.<sup>35</sup> According to both Smith and Marx, profits, whose existence is predicated on the existence of capitalism,

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<sup>35</sup> Karl Marx, *Capital*, trans from 3rd German ed. by Samuel Moore and Edward Aveling; Frederick Engels, ed; rev and amplified according the 4<sup>th</sup> German ed. by Ernest Untermann (New York: Random House) pp.163-173.

represent an unnatural and unjust deduction from what originally and legitimately belongs to wage earners.

This then is the underlining conceptual model of the Marxian exploitation theory. However, as indicated earlier, it is not without significant problems. First, let us carefully define our terms. Profit is an excess of sales receipts from the sale of commodities over the *money cost* of manufacturing those items. A Capitalist or Entrepreneur is one that buys for the purpose of future selling. That is, they make productive expenditures. Wages are money paid in exchange for labour services—not for the goods produced by labour but strictly the labour services.

Given these definitions, workers incomes in the pre-capitalist economy, postulated by Smith and Marx, look not like wages but profits. Workers producing and selling goods receive not wages for their labour but sales receipts for their commodities. As John Stuart Mill informs us; “Demand for commodities, is not demand for labour.”<sup>36</sup> When we buy goods, we are not paying wages and when we sell goods we are not receiving wages. What we pay and receive in the buying and selling of goods is product sales revenue.

So, while it is correct to describe all income receivers in this “original state” as workers, it is important to realise that these incomes are not wages. What they are is simply profits. Indeed, in such a pre-capitalist economy all income based on the production and subsequent sale of goods must be profit. Because the workers in this economy earn sales receipts, and not wages, and given that these same workers have zero money costs of production to deduct from sales revenue, sales revenue must equal profit. The workers in this economy have zero money costs because, as stipulated by Smith and Marx, they have not engaged in capitalist behaviour. They have not purchased any capital items to enable the production of their commodities and therefore generate sales receipts, meaning they simply do not have any outlays of money (costs) to deduct from their sales revenue.

To clarify further, profit is sales revenue minus the costs associated with production. If it costs me \$50 to produce a good and I am able to sell it for \$100 then I have made a \$50 profit. If I am able to produce the item next time for only \$25 but can still sell it for \$100 then my profit

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<sup>36</sup> John Stuart Mill, *Principles of Political Economy*, Ashley ed. (1909; reprint ed., Fairfield, N.J.: Augustus M. Kelly, 1976) pp.79-88.

is \$75. If instead it costs me \$1 to produce this \$100 item then my profit will be \$99. If I have no associated production cost of producing the good, then my profit will be the full magnitude of the sales revenue, or \$100.

It is exactly this last situation that the labourers in Smith's "original state" and under Marx's "simple circulation" find themselves. A worker in such an economy may collect berries or mushrooms from the commons and then sell them. Because there are no money costs associated with such an enterprise the full sales revenue can be considered profit. Smith himself unwittingly gives us an excellent example: "In some parts of Scotland a few poor people make a trade of gathering, along the sea-shore, those little variegated stones commonly known by the name of Scotch Pebbles. The price which is paid to them by the stone cutter is altogether the wages of their labour; neither rent nor profit make any part of it."<sup>37</sup> But this is clearly profit. The price of the stones is sales revenue not a wage payment. Given that the workers expend no production expense on the collection of these stones, then the full magnitude of sales revenue is profit.

So, in the terminology of Marx, the M of his simple circulation is actually an M' that has not been preceded by any M to eventuate it. The absence of capitalists from the "original state" means that there is no productive expenditure on the manufacturing of goods and thus no such prior M. Only with the advent of a capitalist economy does an M appear, to be deducted from M'. Therefore, the full amount of Marx's M in a pre-capitalist economy is profit and not wages. Thus, in the pre-capitalist sequence C-M-C, everything is, in fact, surplus value or 100% profit. It is only in the capitalistic circulation sequence M-C-M', that we see a smaller portion of incomes characterised as profit or surplus value.

This idea that all income is profit and no income is wages in a "simple circulation" economy can be seen in David Ricardo's argument that "profits rise as wages fall and fall as wages rise."<sup>38</sup> Ricardo states that the wages paid in production are paid for by the capitalist, out of savings or capital and not by consumers. If, as in the "original state", there are no capitalists in the economy then there can be no wages paid as production expenditure, and if there is no payment of wages for production, the entire income earned in Ricardo's model must be profits.

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<sup>37</sup> *Wealth of Nations*, bk. 1, chap. 6 [1:58]

<sup>38</sup> David Ricardo, *Principles of Political Economy and Taxation*, 3<sup>rd</sup> ed. (London, 1821), chap 6.

The basic conception of the Marxian exploitation model is simply wrong. It has been established that wages are not the primary source of income, but rather that profits are. It is wages and not profit that comes into existence with the capitalist. It is the capitalist that creates the phenomena of wages, and productive expenditure. As such, it is incorrect to view profits as a deduction from wages in capitalist economy. Indeed the exact opposite is true, wages and other costs of production are deductions from sales revenue, which was originally entirely profit. The introduction of capitalism causes the creation of wages and the steady reduction of the relative level of profits. The more capital intensive an economy becomes, the more buying in order to sell or productive expenditure relative to sales revenues. This implies ever higher wages relative to sales revenue, and therefore the lower are profits relative to sales revenues. Capitalists and entrepreneurs, therefore, do not exploit or impoverish wage earners, but, instead make it possible for people to become and exist as wage earners. It is not the creation of profits that they are responsible for, but instead the creation of wages. Without entrepreneurs there would not be the phenomenon of wages associated with the manufacture of goods for sale.

In the absence of the capitalist, the only way to generate income with the manufacture and subsequent sale of commodities would be to produce and sell those products one's self. That is, to act as profit earner. But the manufacture and sale of goods has requisite conditions. One will need ownership of some space to engage in the production of goods, as well as manufacturing, or at least the inheritance of, the tools vital for the enterprise. Nor should we forget the collection of the resources to be fashioned into the final product. This is not a practical way for a large number of people to exist. It is the entrepreneurial use of capital that allows people to survive by selling their labour, rather than trying to sell the products of that labour. Instead of exploitation of the worker by the capitalist, we find, instead, a close and mutually beneficial relationship, predicated on the fact that entrepreneurial use of capital allows a great number of people to exist and indeed flourish as wage earners.

Indeed, the greater the capitalisation of an economy the greater share of all income that will be wages and the smaller the share that will be profits. If workers want a greater proportion of the economic pie, then it is a further intensification of capitalism they need, or in Marxian notation more  $M$  in respect to  $M'$ . This represents an increase in productive expenditure (costs of production and wages), and therefore lower profits, relative to revenue generated from sales. The greater the number of entrepreneurs, backed by increasing amounts of capital, is then, what is required to achieve such an outcome.

The economic history of F.A. Hayek lends support to this above proposition, namely that it is the existence of entrepreneurs with access to capital that create wages, whereas profits are the natural and original form of income. He states:

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 expropriation of the masses suggest....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.<sup>39</sup>

The primacy of wages doctrine, then, does not stand up to theoretical nor historical scrutiny.

### **8. Labour's right to the whole produce**

Marxists claim the right of the whole produce in the name of the workers. That the wage earner, under capitalism, has no control over the final product of his efforts is, therefore, considered alienated from his produce. The labourer is unable to relate to his work on any meaningful level, it is asserted. His horizons are limited to the task immediately at hand, an infinitesimal role in the context of the firm's total productive operations. As such, the wage earners ability to flourish is seriously encumbered. Socialism, on the other hand, will abolish the piecework system and, it is claimed, turn work into the joyous expression it should be.<sup>40</sup>

It is beyond the scope of this paper to consider in detail the implausible alienation theory as it is to provide an extensive defence of the division of labour system.<sup>41</sup> However, it is essential to examine this claim that wage earners are entitled to the whole of produce. It is a statement of fact to point out that the manual worker is only involved with an infinitesimal part of an organisations total productive enterprise. But this proof positive that such a worker cannot be in any way considered responsible for the firm's product/s. The manufactured good does not emerge out of some chaotic (yet somehow fortuitous), interaction between unintegrated and isolated steps of the productive process. Rather, these steps of production have been carefully planned, co-ordinated and regularly improved by entrepreneurial behaviour. The entrepreneur creates the division of labour essential to advanced production.

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<sup>39</sup> F.A. Hayek, *Capitalism and the Historians*, (Chicago: University of Chicago Press, 1954), pp.15-16.

<sup>40</sup> Karl Marx, *Economic and Philosophic Manuscripts of 1844*; Karl Marx and Fredrich Engels, *The Holy Family: A Critical Criticism* (1845); *The Communist Manifesto* (1848); Friedrich Engels, *Anti-Durhing* (1878).

<sup>41</sup> For a defence of the division of labour system and a critique of the Alienation doctrine see Reisman pp.123-134.



Let us explore this claim further. Labour does indeed provide and make possible all human production. But we must be very clear about what is the essential characteristic of labour that enables this production. It is not mere muscular exertion that makes production possible but labour's guiding and directing intelligence. As Ludwig von Mises states:

Production is not something physical, natural, and external; it is a spiritual and intellectual phenomenon. Its essential requisites are not human labour and external natural forces and things, but the decision of the mind to use these factors as means for the attainment of ends. What produces the product are not toil and trouble in themselves, but the fact that the toiling is guided by reason.”<sup>42</sup>

Thus, all labour is essentially the labour of direction. It is because it is the individual's guidance and direction of a tool that we can say he, and not the tool, creates the product. The tool, whether it is a spade, a mechanical excavator, explosives, or even a laser, does not create, but rather is the means by which an individual who uses it produces. It is in this same sense that we say that a man commits murder and not the gun he used for that purpose.

It is entrepreneurs that provide the required guiding and directing intelligence to more roundabout production techniques. The wage earners certainly play their part and supply a certain level of labour direction to the tasks that make up their job. However, it is the entrepreneur that provides a higher level of directing intelligence, over the whole production process and not over individual steps of the production. Profits, then, are attributable to the labour of entrepreneurs. This is yet another illustration of the primacy of profits over the primacy of wages.

## **9. Conclusions**

Given that profits are income created by the labour and efforts of entrepreneurs and capitalists, that is, their labour provides the requisite directing intelligence at the highest level in the productive enterprise we are left with an entirely new interpretation of the labour's right to the whole produce doctrine. It is not the workers as wage earners that are entitled to the final product of the firm's production and then its full sale value, but rather the entrepreneur. The right to the full product is satisfied when the entrepreneur takes possession of the product and

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<sup>42</sup>Ludwig von Mises, *Human Action; A Treatise on Economics*, (Auburn; The Ludwig von Mises Institute; 1998) p.141.

then its full value, because it is the entrepreneur that is, and not the workers, the primary producer. The entrepreneur's employees are certainly an aid to the production of his goods, but this is not the same as being the prime mover of the production process.

By acknowledging that results should be credited to those who imagine then execute their achievement at the highest level, it becomes impossible to evade the simple truth that entrepreneurs and capitalists are legitimately entitled to the entirety of their profits. Indeed, we often talk of Abel Tasman discovering New Zealand or Lord Nelson winning the battle of Trafalgar or the Prime Minister's economic policies. We make these attributions even though Tasman could not have made his discovery without the help of his crew, nor could Nelson have attained victory without his fellow sailors, nor can the Prime Minister enact economic policy without the aid of the staff from several ministries. Yet, we acknowledge that the help these people provide is simply the means to an ends envisioned by those supplying the highest level of directing intelligence. The guiding reason, vision, planning and integration starts at the very top, while the implementation of the achievement comes up from the bottom.

Clearly then, the products of, say, Virgin must be attributable to Richard Branson (and any lesser known business associates). The labour's right to the whole product and its subsequent full value is satisfied fully when a Branson and any lesser known associates, are paid by the consumers of their goods for their products. The final product is theirs, and not their employees'. The help the workers provide is fully compensated for by the salary payments made by the entrepreneur to the employees.

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