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Hobson's "Surplus Income" and Its Distribution

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This month marks the fiftieth anniversary of the death of John A. Hobson (1858–1940), the seminal interpreter of the theory of economic imperialism. Hobson is the man Ben Seligman called "A British Institutionalist" [Seligman 1962, p. 221]. Hobson's status as an institutionalist is not addressed in this paper. What is certain, however, is that Hobson's fit within the mainstream of British economics was uncomfortable. Alon Kadish has shown that Hobson was not the absolute outsider he portrayed himself to be. Nonetheless, Hobson did encounter difficulties adding economics to his course of lectures in the London extension movement. Kadish convincingly argues that H. S. Foxwell, not F. Y. Edgeworth, was the "economics professor," mentioned in Hobson's autobiography who blocked Hobson's appointment. [Kadish 1990, pp. 141–49].[1]

A self-styled heretic, as demonstrated by the title of his intellectual autobiography, *Confessions of An Economic Heretic*, Hobson's study of economics is concerned with the provisioning of a society as opposed to an economics that investigates allocative efficiency or economizing. Hobson refused to accept an economic analysis that divorced the economy from the society of which it was a part. He insisted on an analysis of the economy in its organic co-operative setting, with its potpourri of social economic relations. He argued that if a natural science metaphor

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was to be utilized, biology's analysis of the organism was the proper model. It is well know that Hobson was an underconsumptionist.

What is less well known is that he offered a theory of income distribution that explained the nature of underconsumption. A further implication of the existing income distribution was that the economy was constantly producing beneath its potential while starving the public sector and perhaps its less fortunate members.

Hobson rejected marginal productivity as the basis of income distribution. He objected to the marginal productivity approach on two grounds. First, it was individually based, whereas Hobson viewed production as socially based. Second, marginal productivity only applied to perfectly competitive conditions, a circumstance he found to be frequently irrelevant even in the first quarter of the twentieth century [Hobson 1910, pp. 112–20; 1926, Chap. 3]. Clearly an alternative theory was in order.

Hobson's contribution was to present a theory of distribution that analyzed factor incomes according to cost and surplus elements. The unnecessary nature of the surplus element of factor incomes, which provided no incentive for production, and the potential harm caused by the misuse of surplus income formed the basis for the remedial social policy that always accompanied Hobson's social economic analysis.

The analysis of the distribution of the surplus first appeared in *The Economics of Distribution*, a book Hobson claimed had little impact or exposure [Hobson 1938, p. 48]. A refined analysis of distribution, particularly including the entrepreneur as an essential factor of production, was the centerpiece of *The Industrial System*, subtitled *An Inquiry into Earned and Unearned Income. The Industrial System* is the main source used in this paper. It should be noted, however, that two of Hobson's earliest works *The Evolution of Modern Capitalism* and *The Physiology of Industry* each contain nascent elements of Hobson's distribution analysis.

Costs

The analysis began by jettisoning the usual income categories of wages, rent, interest, and profit, and substituting the notion that all factor incomes contain elements of cost and surplus. The cost element has two aspects. The first is a maintenance or wear and tear payment that allows the factor to sustain its productive power. This is the "minimum wage" or "bare subsistence wage." In the case of labor this includes the cost of raising a family. The other aspect of cost is a moral ingredient.

Labor, in particular higher grades of labor, needs a payment that will sustain the will or motivation to provide the ongoing effort of work. The actual subsistence wage includes both the maintenance cost and the "necessary stimulus for motive" [Hobson 1910; p. 63]. The subsistence wage of labor, including the material means for child rearing, the depreciation allowance of capital, and the necessary expenditures to replenish the productivity of land, comprise the cost elements of the usual factors of production [Hobson 1910, pp. 63, 69, 75]. If any factor did not gain an income equal to its subsistence rate, its productive-power would eventually be extinguished. A subminimal "sweated" income was only possible when factor supply exceeded the needs of industry, in which case any exhausted input could easily be replaced by another. Hobson did not fail to note that this was the actual case in some of the most common forms of employment.

The determination of minimum subsistence income was not left completely to natural or technical determinants. The actual minimum also was affected by social standards and customs. The minimum unit of subsistence was the family rather than the individual. This meant that social norms may determine that a husband need not earn the full minimum subsistence because the wife, and even the children, would contribute the remainder. Further the size of the family affected the minimum wage. Hobson wrote:

> The proportion of the adult male or female wage to the aggregate family wage will vary widely according to the district and trade, and may be affected greatly by legal and customary considerations.
>
> At any given time and place the price an entrepreneur will have to pay in setting up a business will be determined by the proportion the men and women he employs have to contribute to the conventional standard of living in their class [Hobson, 1910, p. 85].

The social status of a particular employment has an impact on its income. Custom deems certain roles deserving of higher incomes independent of objective minimum needs. These generally professional occupations will be compensated at a higher rate than the more common forms of labor—this in spite of the obvious satisfaction generated by the work process itself. Hobson observed, "The respectability or dignity which tradition attaches to certain learned professions and officials, instead of operating to reduce their rate of pay, often serves to enhance it, because it is recognized that the physician, the lawyer, the municipal official, ought to live in a style consistent with the dignity of the post or the profession" [Hobson 1910, p. 86]. Hobson did not argue that custom or social norms set the rate of pay. Indeed the most powerful determinant was the difficulty of attaining the skill or knowledge to gain employment in a particular trade or profession. Hobson stands out from the mainstream because society's role is acknowledged as a part of the normal process of income determination and not merely as a friction that prohibits the market from setting incomes based on marginal productivity.

Hobson's explicit introduction of the entrepreneur as the factor that organizes production contrasts with marginal productivity analysis. The marginal productivity theory of distribution treats production in a mechanical fashion; each factor was accorded a separate productivity, and production proceeded without any acknowledgement or recognition of a coordinating or directing role. Hobson argues that production is a co-operative process and that the entrepreneur plays the coordinating and organizing role.

The entrepreneur was a multi-faceted actor whose ability to organize the multiple aspects of production allowed the claim to profits, the residual from revenue after the expenses of wages, interest, and rent are met. Hobson explained:

> The entrepreneur is more than a mere manager. He has an eye for a profitable project, he plans a business, buys the uses of land, labor, and capital of various sorts, embodies their productive power in materials which he likewise purchases, and markets the product. The difference between these expenses of production and the prices obtained for the product constitutes his profit [Hobson 1910, p. 58].

Hobson credited the entrepreneur with a genuine contribution to production and proposed a legitimate cost of entrepreneurship analogous to the costs of the other factors of production.

> We must give separate consideration to the entrepreneur, regarding him as the owner of a factor of production called ability, for the use of which he receives a portion of the product known as profits. This term "profit" is so elusive that I must here insist upon fastening it down as the payment for the activity of the entrepreneur, excluding from it entirely interest and payment for risks, but including what is commonly termed wages of management or superintendence, so far as these functions are actually performed by the entrepreneur. [Hobson 1910, pp. 122–23].

The entrepreneur's income, or profit, could be divided into necessary and unnecessary elements. Profit as a category of income was the same as the incomes of the other factors of production. Hobson's theory of distribution acknowledged the productivity of all the factors of production, including entrepreneurship and capital. Each factor necessarily had to receive an income that would sustain its productive power. This income was a cost of production, a necessary payment, if production was to proceed.

Surplus

The existing industrial system, however, produced an income that more than met costs. The income above costs was the surplus. The surplus was divided into necessary and unnecessary or unproductive surplus. Since a progressive industrial system required more and better factors of production, the needs of progress dictated that factors earn a "necessary surplus" above the costs of reproduction. The additional payment was necessary to expand the margin of factor usage in the respective factors. Quite simply, and unsurprisingly in a market economy, if more of a given factor was to be utilized, a higher payment was necessary.

A progressive economy does not merely increase the quantity of factors; it also increases the quality of the factor inputs. The stimulation of the "progressive efficiency" of the existing units of labor, for instance, mandated a surplus income to provide the conditions for improvement. Whether this was an improved diet, education, better hygiene, or some other element it would require that the factor receive an additional payment. This payment for "progressive efficiency" came out of the surplus, it was above the costs of simple reproduction or maintenance. The needs of progress—not individual need—make this surplus necessary. This is indicative of Hobson's criticism of individualist theories of distribution. The necessity of this element of factor income is based on social progressivity rather than on an innate individual necessity.

Hobson also saw the need to nurture progressive efficiency in capital and entrepreneurship. The development of progressive efficiency validated a rate of interest as a payment to capital and a level of profit over and above the minimum necessary costs of entrepreneurship. Only unreproducable land did not warrant a necessary surplus for progressive efficiency. There was, however, no guarantee that the surplus would be allocated in such a fashion that it met the needs of progressive efficiency, since there was no innate necessity for any factor to acquire surplus elements of income. Furthermore, income more than likely exceeded the combined needs of maintenance and progressive efficiency of land, labor, capital, and entrepreneurship. The surplus above the needs of progressive efficiency was the unproductive surplus and could be a part of any factor's income.

With the possibility of any or all factors earning surplus income, the distribution of the surplus was determined by the relative scarcity of the factors and the bargaining leverage the factor owner could bring to the market. The scarcity could be natural or contrived.

> In every process of every industry, some one or other of the factors is relatively scarce, either by nature or by human contrivance, and can extort a piece of "surplus" payment over and above that payment for which its owners would consent to apply it in production, if they could not get this surplus. This relative scarcity is assisted everywhere by lack of mobility and by lack of knowledge [Hobson 1910, p. 137].

Unless conditions in the market closely approximate those of classic perfect competition, "There remains," as Hobson puts it, "an unearned gain distributed by chance or by force" [Hobson 1910, p. 158]. Unlike the quasi-rents in Alfred Marshall, the unearned surplus was not a temporary phenomenon. Unearned surplus was a seemingly permanent component of the existing distribution of income rather than a sign invoking increased provision of the factor.

Hobson argued that raw or not so raw economic power played a prominent role in the distribution of income. In those cases where the owners of particular factors were able to establish the leverage of scarcity or monopoly, they were able to acquire an unearned share of the surplus, often forcing the income of the relatively plentiful factors toward the minimum subsistence rate. This restricts the resources available for economic progress and confines the economy to function beneath its potential.

Current conditions in the industrial economy were such that the entrepreneur was the most advantageously situated to capture the unnecessary surplus. Hobson argued that the entrepreneurial class, which included the financier, possessed the lion's share of the surplus product.

> But were it possible accurately to separate true profits from other payments, it would, I think, become evident that certain classes of ability in the direction and organization of industry, and the manipulation of markets, were gaining upon the owners of other factors in their power to take surplus wealth, irrespective of their economic need of it for the stimulation of industrial progress [Hobson 1910, p. 135].

The inability to actually measure the surplus or to separate the surplus into necessary and unnecessary components was troublesome, but the impact of the surplus's existence could be observed. Hobson argued that the unfettered distribution of the surplus elements of income was the source of virtually every malady that befell the industrial system [Hobson 1910, p. 78].

While it may appear that even after providing the factors of production with the necessary surplus for productive efficiency there would remain an unnecessary surplus, this was the result of economists' refusal to accept a crucial fifth factor of production. Hobson's social economics included the state as representative of society's positive contribution as a co-operating factor of production. The state was unable to secure a share of the national dividend except by taxation, which chronically under-funded the necessary progressive development and occasionally led to atrophy of essential social capital. Hobson argued, "A strong and progressive State is essential to the stability and progress of industry, and must, therefore, rank as a co-operative agent in the production of the income" [Hobson 1910, p. 81]. Hobson did not deny the possibility that the state could be the recipient of unearned income, but he clearly thought such a condition was an exception that would test the rule.

The ability of any factor to accrue a surplus income independent of productive necessity was precisely the point of Hobson's theory. All factors, including the state as representative of society, were productive, and all needed a minimum level of income to participate in the productive process. The enhanced productivity of modern industrial society created a surplus of unprecedented proportions but did not guarantee that the surplus would be distributed on the basis of need or capacity to efficiently use an income above maintenance. Surplus income was not distributed on the strict basis of productivity, but was most clearly determined by relative scarcity. This meant that some elements of society, generally the entrepreneurial class, would have incomes beyond any need for consumption while others, generally the lower forms of labor and the state, might barely cover the minimum cost of maintenance. A factor in plentiful supply, and lacking guile in bargaining, found its income approaching the bare subsistence and certainly less than the level necessary for improvement.

It is interesting to note that Hobson frequently extols the virtues of competition. He argues that if all factors are freely available, competition in the market will drive costs to a level where consumers will reap the surplus through low prices. What Hobson denies is the relevance of the competitive norm to the actual economy.

The large unearned income that accrued to the relatively scarce factors was the root of underconsumption—Hobson's first heresy, but it also could be tapped for redistribution without affecting the availability of the factor for productive service. The very existence of unearned surplus in factor incomes signified that the economy was operating at less than potential.

Hobson's proposed remedy was a redistribution of income from those with unearned income, either to the state as representative of society as a whole or to the factors without the means for progressive efficiency. Since it was impossible to precisely untangle the unearned surplus elements of income from necessary income, the logical vehicle for redistribution was a progressive income tax. The working hypothesis was that higher incomes were correlated with unearned surplus. Further, it may be prudent to tax the consumption of luxuries, presuming such consumption is inevitably financed from surplus income.

The tax revenue could directly subsidize inadequate incomes or indirectly provide an improved standard of living by providing public goods. Part of the revenue would be retained for providing social capital. Hobson also entertained the idea of the socialization or regulation of those industries characterized by natural scarcity. This would allow for a payment of the full necessary incomes to the contributing factors of production, including the state.

Hobson analyzed the actual distribution of income of the existing economic process, not a theory of what the distribution of income would be in a market economy stripped of the elements of economic power, ignorance, custom, and co-operation. Hobson's analysis of the distribution of income sets the stage for his theory of the trade cycle and his welfare economics. These issues, however, strike me as grist for other chapters in the social and political economics of John Hobson.

Note

1. I am grateful to J.E. King for alerting me to Kadish's paper.

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