Capital, Interest, & Rent

Essays in the Theory of Distribution

Frank Fetter

EDITED BY MURRAY N. ROTHBARD

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Edited with an Introduction by

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PREFACE

I was first apprised of Frank A. Fetter's contributions to the theory of distribution by the references in Ludwig von Mises's *Human Action* (1st ed., New Haven: Yale University Press, 1949; 3d ed., Chicago: Henry Regnery, 1966). Then, while reading Fetter's *oeuvre* in the course of writing my *Man, Economy, and State* (2 vols., Princeton, N.J.: D. Van Nostrand, 1962, reprint ed., Los Angeles: Nash Publishing Co., 1970), I was struck by the brilliance and consistency of his integrated theory of distribution and by the neglect of Fetter in current histories of economic thought, even by those that are Austrian oriented. For Fetter's systematic theory, while challenging and original (particularly his theories of interest and rent), was emphatically in the Austrian school tradition.

The present volume includes all of the essays in which Fetter developed and presented his theory of distribution; the only important writings excluded are his two treatises: *The Principles of Economics* (New York: The Century Co., 1910) and *Economic Principles* (New York: The Century Co., 1915).

I am indebted to Professor Emeritus Joseph Dorfman of Columbia University for examining my introduction and the collection of essays with his usual thoroughness and for making many valuable suggestions. The editor of this series, Professor Laurence S. Moss of the University of Virginia, also made many helpful suggestions. Neither is responsible for any errors that may remain.

I would like to thank the American Accounting Association, publishers of the *Accounting Review;* the editors of the *Quarterly Journal of Economics;* the Academy of Political Science, publishers of the *Political Science Quarterly;* the University of Chicago Press, publishers of the *Journal of Political Economy;* and Macmillan Publishing Company for permission to reprint the articles in this volume.

Murray N. Rothbard
New York, N.Y.
March, 1976

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Introduction

1.

Frank Albert Fetter (1863-1949) was the leader in the United States of the early Austrian school of economics. Born in rural Indiana, Fetter was graduated from the University of Indiana in 1891. After earning a master's degree at Cornell University, Fetter pursued his studies abroad and received a doctorate in economics in 1894 from the University of Halle in Germany. Fetter then taught successively at Cornell, Indiana, and Stanford universities. He returned to Cornell as professor of political economy and finance (1901-1911) and terminated his academic career at Princeton University (1911-31), where he also served as chairman of the department of economics.

Fetter is largely remembered for his views on business "monopoly" (see his *Masquerade of Monopoly* [New York: Harcourt, Brace and Co., 1931]). But long before he published his work on monopoly in the 1930s, he developed a unified and consistent theory of distribution that explained the relationship among capital, interest, and rent. While Fetter's theoretical work, like much of capital and interest theory in recent decades, has been generally neglected, much of it is still valuable and instructive today. In my opinion, microeconomic analysis has a considerable way to go to catch up to the insight that we find in Fetter's writings in the first decade and a half of this century.

Apart from his two lucidly written treatises (*The Principles of Economics* [New York: The Century Co., 1904]; and *Economic Principles* [New York: The Century Co., 1915]), Fetter's major contributions to distribution theory appeared in the series of journal articles and shorter papers that I have collected to form this volume. It was difficult for me to classify Fetter's work into the categories of "capital," "rent," and "interest," because his was an unusually systematic and integrated theory of distribution, all areas of analysis being interrelated.

Fetter's point of departure was the Austrian insights that (1) prices of consumer goods are determined by their relative marginal utility to consumers; and (2) that factor prices are determined by their marginal productivity in producing these consumer goods. In other words, the market system imputes consumer goods prices (determined by marginal utility) to the factors of production in accordance with their marginal productivities.

While the early Austrian and neoclassical schools of economics adopted these insights to explain prices of consumer goods and wages of labor, they still left a great many lacunae in the theories of capital, interest, and rent. Rent theory was in a particularly inchoate state, with rent being defined either in the old-fashioned sense of income per year accruing to land, or in the wider neo-Ricardian sense of differential income between more and less productive factors. In the latter case, rent theory was an appendage to distribution theory. If one worker earns $10 an hour and another, in the same occupation, earns $6, and we say that the first man's income contains a "differential rent" of $4, rent becomes a mere gloss upon income determined by principles completely different from those used to determine the rent itself.

Frank Fetter's imaginative contribution to rent theory was to seize upon the businessman's commonsense definition of rent as the price per unit service of any factor, that is, as the price of renting out that factor per unit time. But if rent is simply the payment for renting out, every unit of a factor of production earns a rent, and there can be no "no-rent" margin. Whatever any piece of land earns per year or per month is rent; whatever a capital good earns per unit time is *also* a rent. Indeed, while Fetter did not develop his thesis so far as to consider the wage of labor per hour or per month as a "rent," it is, as becomes clear if we consider the economics of slavery. Under slavery, slaves are either sold as a whole, as "capital," or are rented out to other masters. In short, slave labor has a unit, or rental, price as well as a capital value. Rent then becomes synonymous with the unit price of *any* factor; accordingly, a factor's rent is, or rather tends to be, its marginal productivity. For Fetter the marginal productivity theory of distribution becomes the marginal productivity theory of rent determination for every factor of production. In this way, Fetter generalized the narrow classical analysis of land rent into a broader theory of factor pricing.

But if every factor earns a rent in accordance with its marginal product, where is the interest return to capital? Where does interest fit in? Here Fetter made his second vital and still unappreciated contribution to the theory of distribution. He saw that the Austrian Eugen von Böhm-Bawerk, in the second volume of his notable *Capital and Interest*, inconsistently returned to the productivity theory of interest after he had demolished that theory in the first volume. After coming to the brink of replacing the productivity theory by a time-preference theory of interest, Böhm-Bawerk withdrew from that path and tried to combine the two explanations—an eclecticism that capital and interest theory (in its "real" form) has followed ever since.

Fetter approached the problem this way: If every factor earns a rent, and if therefore every capital good earns a rent, what is the source of the *extra* return for interest (or "long-run normal profit," as it is sometimes called)? In short, if a machine is expected to earn an income, a rent, of $10,000 a year for the next ten years, why does not the market bid up the selling price of the machine to $100,000? Why is the current market price considerably less than $100,000, so that in fact a firm that invests in the machine earns an interest return over the ten-year period? The various proponents of productivity theory answer that the machine is "productive" and therefore should be expected to earn a return for its owner. But Fetter replied that this is really beside the point. The undoubted productivity of the machine is precisely the reason it will earn its $10,000 annual rent; however, there is still no answer to the question why the market price of the machine at present is not bid high enough to equal the sum of expected future rents. Why is there a net return to the investor?

Fetter demonstrated that the explanation can only be found by separating the concept of marginal productivity from that of interest. Marginal productivity explains the height of a factor's rental price, but another principle is needed to explain why and on what basis these rents are *discounted* to get the present capitalized value of the factor: whether that factor be land, or a capital good, or the price of a slave. That principle is "time preference": the social rate at which people prefer present goods to future goods in the vast interconnected time market (present/future goods market) that pervades the entire economy.

Each individual has a personal time-preference schedule, a schedule relating his choice of present and future goods to his stock of available present goods. As his stock of present goods increases, the marginal value of future goods rises, and his rate of time preference tends to fall. These individual schedules interact on the time market to set, at any given time, a social rate of time preference. This rate, in turn, constitutes the interest rate on the market, and it is this interest rate that is used to convert (or "discount") all future values into present values, whether the future good happens to be a bond (a claim to future money) or more specifically the expected future rentals from land or capital.

Thus, Fetter was the first economist to explain interest rates solely by time preference. Every factor of production earns its rent in accordance with its marginal product, and every *future* rental return is discounted, or "capitalized," to get its present value in accordance with the overall social rate of time preference. This means that a firm that buys a machine will only pay the *present* value of expected future rental incomes, discounted by the social rate of time preference; and that when a capitalist hires a worker or rents land, he will pay now, not the factor's full marginal product, but the expected future marginal product discounted by the social rate of time preference.

A glance at any prominent current textbook will show how far economics still is from incorporating Fetter's insights. The textbook discussion typically begins with an exposition of the marginal productivity theory applied to wage determination. Then, as the author shifts to a discussion of capital, "interest" suddenly replaces "factor price" on the y-axis of the graph, and the conclusion is swiftly reached that the marginal productivity theory explains the interest rate in the same way that it explains the wage rate. Yet the correct analog on the y-axis is not the interest rate but the rental price, or income, of capital goods. The interest rate only enters the picture when the market price of the capital good as a whole is formed out of its expected annual future incomes. As Fetter pointed out, interest is not, like rent or wages, an annual or monthly income, an income per unit time earned by a factor of production. Interest, on the contrary, is a rate, or ratio, between present and future, between future earnings and present price or payment.

Fetter's theory makes it impossible to say that capital "earns," or generates an interest return. On the contrary, the very concept of capital value implies a *preceding* process of *capitalization*, a summing up of expected future rental incomes from a good, discounted by a rate of interest. Rent, or productivity, and interest, or time preference, are logically prerequisite to the determination of capital value.

2.

Frank A. Fetter's earliest article in this collection, a review of Frank W. Taussig's *Wages and Capital: An Examination of the Wages Fund Doctrine* (New York: D. Appleton, 1896), was written in 1897 and sets the pace for the articles in the first part of this book. Here Fetter criticized Taussig's attempt to revive the classical notion of the "wage fund." Rather than attempting to explain aggregate wage payments, Fetter recommended explaining individual wage rates.

Fetter's first full-length article on capital was his "Recent Discussion of the Capital Concept" (1900). In it he compared the theories of capital offered by Böhm-Bawerk, John Bates Clark, and Irving Fisher. Fetter did less than full justice to Böhm-Bawerk's subtle insistence on the defects of the idea of capital as merely a fund, especially in comparing or measuring concrete