Funding the Future

What if labour was not a cost?

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I have been thinking about something that is so obvious within conventional accounting that almost no one thinks to question it. It is the assumption that labour is a cost.

Every accountant thinks this. A business has sales, and from those sales it deducts the costs incurred in generating them. Those costs include materials, energy, rent, depreciation and, most importantly for many businesses, wages and salaries. What is left after those costs have been deducted is called profit.

But suppose we ask a different question. Suppose that the purpose of a business was not to maximise the return to capital but was instead to maximise the sustainable return to labour. What would accounting look like then?

I think the answer is that it would look very different indeed, and there is no reason why this need not be the case, and why it should not be. That is because there is unlimited financial capital in this world, and limited labour, which is why it makes complete economic sense to presume that the return to labour is what an economy should maximise.

Critically, this matters because accounting is not neutral. Accounting decides what we record, what we ignore, where we draw boundaries and, crucially, what we call income. Those decisions profoundly influence how we understand economic activity, and the treatment of labour proves the point.

Who gets the residual?

Conventional accounting broadly assumes that revenue, less labour costs and other costs, leaves profit attributable to capital. Of course, actual accounts are more complicated than that, but the essential logic is clear. Labour is treated as a cost. The payment of wages reduces profit. If wages increase by £1 and nothing else changes, profit falls by £1.

From the perspective of the owners of capital, that makes complete sense. In the currently accepted accounting framework, the worker's gain is their loss. But there is no natural economic truth in this accounting. Instead, that accounting has adopted a perspective. It has been decided that the return to labour is a cost, while the return to capital is the residual we call profit. That is a choice.

What if we choose differently? Suppose instead that the purpose of the company is to maximise the sustainable return to labour whilst maintaining the capital required for the business to continue. The calculation might then be revenue, less external inputs, less the cost of maintaining capital and an appropriate required return to capital, with what remains being the return to labour.

Suddenly, wages have a very different character. They are no longer simply a cost incurred on the way to calculating the return to capital. They are part of the return that the organisation exists to generate.

Imagine, for example, a company with sales of £1 million. It buys £300,000 of goods and services from elsewhere and pays £500,000 to its employees. Suppose another £50,000 is required to maintain its productive capital (which is the estimated cost called depreciation provided in most accounts) and to provide an appropriate return to those supplying financial capital. Conventional accounting would then say that there is £150,000 of profit left out of which a dividend might be paid over and above the return already required by those supplying capital.

But why should that £150,000 be the measure of success? Why does the £500,000 paid to labour count as a cost whilst the £150,000 left for capital counts as the residual whose maximisation supposedly indicates that the business is doing well? There is nothing inevitable about that conclusion. It only follows from the perspective from which the accounts have been prepared.

An alternative accounting could say that £50,000 is the necessary cost of maintaining and rewarding financial capital, leaving £650,000 as the return generated for labour. Of that sum, £500,000 has already been distributed as wages, leaving another £150,000 available for employees, whether as additional pay, enhanced pensions, improved working conditions, reduced working hours, better training, greater employment security or other provision for their future benefit.

Nothing about the underlying economic activity has changed. The company has sold exactly the same things, employed exactly the same people, used exactly the same physical resources and generated exactly the same amount of value. All that has changed is the question that the accounting is designed to answer, which is who is it that has a claim on this return?

Accounting as political economy

This change in perspective has significant consequences.

If the company in my example increased wages by £100,000, conventional accounting would report that its profit had fallen by £100,000. On the conventional measure, its performance would appear to have deteriorated. But if the purpose of the company was to maximise the sustainable return to labour, precisely the opposite conclusion might be reached. The company would have succeeded in distributing another £100,000 to the people whose work helped create its value.

The accounting definition of success would have been reversed.

There are, of course, limits to this argument. Labour still has an opportunity cost. A business needs to know how much labour is required to produce something. It needs to know whether resources are used efficiently, and it cannot simply ignore what it pays employees when making decisions, although it might more appropriately consider their time. But none of that requires us to assume that labour must be treated as an expense whilst the return to capital must be treated as the residual measure of success.

That assumption reflects a particular theory of the firm. More specifically, it reflects a theory in which the company exists primarily for the benefit of those who own its capital but who, in many cases, have no legal involvement in its affairs. Accounts designed around the needs of capital inevitably answer the questions that capital wants answered. They do not necessarily answer the questions that employees, communities, governments or society need answered.

Value distribution

We could instead produce accounts that began with the value created by an enterprise and then showed how that value was distributed.

They could show:

* what is required to maintain productive capital,
* what provision is required to ensure sustainability,
* what return is necessary to secure the financial capital the business requires, and
* what return is generated for labour.

That last return could include wages, pensions, benefits, training, improved working conditions and whatever surplus remains available to enhance the wellbeing and security of those who work within the enterprise.

The resulting measure of performance would not be profit maximisation. It would be the maximisation of the sustainable return to labour, subject to maintaining the resources required to ensure that the enterprise could continue to meet need in the future. The going concern principle would still, in other words, apply, which is what almost all workers desire, and have most interest in maintaining.

Capital maintenance

That point matters. No business can distribute today what must be retained to ensure that productive capacity, human capability and environmental resources remain available tomorrow. Capital maintenance, properly understood, is essential to any meaningful calculation of income and is specifically provided for in what I note above. But once that requirement has been satisfied, there remains a profoundly important question about who should receive the residual.

Conventional accounting provides an answer without ever admitting that it has asked the question. Its answer is capital.

I suggest we could answer labour instead.

Once we realise that possibility, something significant follows.

What accounting is for

Accounting would not then simply describe the economy it is presumed we have. It might also help us understand what that economy is for. If labour is always described as a cost whilst profit is described as the principal measure of success, we should hardly be surprised that businesses seek to suppress wages in pursuit of higher profits. The accounting framework tells them that doing so represents improved performance.

Change the accounting objective, however, and increasing the return to labour can become evidence of success rather than failure.

The accounts would still balance. Double-entry bookkeeping would remain entirely intact. The transactions would be exactly the same. What would have changed would be the purpose for which the information was organised and the question that the resulting accounts were intended to answer.

That suggests that accounting is considerably more political than most accountants like to admit. The decision as to whether labour or capital gets the residual is not a bookkeeping necessity. It is a choice about whose interests the enterprise exists to serve.

Maybe it is time we designed accounting systems that recognised that possibility. Maybe, in other words, we should start accounting as if work, and the people who do it, really matter, and matter most of all, because without it there could be no return to capital.