Earned Income and Unearned Income

Taxes distinguish between earned and unearned income, but tax definitions are different from economic meanings.

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The terms “earned” and “unearned” income do not have single meanings. Dictionaries have inconsistent definitions. One common definition is that earned income comes from labor, while unearned income comes from the ownership of assets. But “earnings” also mean any profits obtained by business, including profit from entrepreneurship. As the terms are in common use, yet the concepts have had little analysis, I will here attempt to derive a meaningful distinction.

At the roots, earned income is wages, and unearned income is land rent. Social Security earned income, because the funds originate in wages. What about gifts? If one has received a gift or inheritance, the recipient has not worked for the funds. But wages gifted to another are still wages, so the gift is earned income if its origin is wages and unearned if its origin is land rent.

Next, consider compensation for injuries. The compensation gain is offset by the loss from the injury, so there is no net income. That applies also to pollution levies. The income from these levies are offset by the loss of well being from the pollution, so there is no net gain. In the case of toll charges that prevent congestion, that income is an earned return on the infrastructure investment. I build a bridge, I charge a congestion toll, and that compensates me for my labor.

What about other income, such as interest? For the analysis, first consider a pure market economy, free of any taxes or privileges, and in which all the land rent is distributed in cash equally among the population. The rent distribution is unearned. Since all rent has been collected, all remaining income is earned. If the people are equally the proper owners of the land rent, they deserve to receive it. Therefore, we discard the meaning of “earned” income as deserved.

A person saves $100 from his wage. With all the land rent being collected, the purchase price of land is zero. Borrowing is therefore not for land purchase, but for investment in education and in capital goods. Now suppose a worker borrows that $100 to pay for training that then increases his wage. The interest the worker pays on the loan is a part of his wage that he is paying to the lender. The origin of the saved funds is wages, and the origin of the interest payment is wages. Therefore the interest income is wages.

The fact that the interest is a return on asset value is not relevant. Therefore, the analysis here differs from the usual definitions of unearned income as derived from asset values.

The same analysis applies to income from dividends. After having paid the land rent to the relevant community, none of the dividends include land rent. Therefore, originating in labor and capital goods, dividends are earned income.

Now let us analyze capital gains and losses, the change in asset values. The rent having been collected, if a company does well and its share prices rise, that is not a result in rising land value, and is therefore a return on entrepreneurship and investment, and so, earned income.

Now consider an economy in which government taxes labor and does not tax rent. Now the landowners are receiving the unearned income that is rent. When some of that rent is saved and obtains i f the funds is rent, and that interest is unearned. If the funds are borrowed by a worker who pays the interest from wages, since the source of the savings is rent, the interest income is unearned, even if the origin of the interest payment is wages.

Finally consider wages loaned by a worker to someone who borrows to buy land. The landowner uses rent to pay interest on the loan.

To analyze this, let's take a more extreme example, that of a worker who uses wages to buy a slave. Some of what the slave could have earned as a free man is unjustly taken by the slave owner. This theft is not the earned wages of the slave owner, even though the owner used his wages to buy the slave.

Going back to the land case, if the morally proper owners of the land are the members of the community, then the rent has been stolen from them, and if some of the rent goes to a worker who purchased the land or loaned to someone who purchases the land, the rent is still not earned.

Applied to today's economy, it would be difficult, if not impossible, to distinguish which parts of interest, dividends, and capital gains came from wages versus land rent. But we can consider the portion of wages and yields to capital goods, versus the portion of land rent, in national income, to be a rough guide, and apply that ratio to income from financial assets.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary’s commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary’s areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.