Buying power and the triple crisis

Michael Joffe
Imperial College London

<u>Preliminary draft</u>

Power and economics

Capitalism and power

The capitalist economy has a power structure, although this is invisible in much of economics. The traditional Marxist view is that this is a dichotomy, the relations of production between capital and labour, but a more general position may be more appropriate, that the capitalist firm is an authority structure, with a management group in control and with various levels or grades of labour below that. In addition, the relationship between capitalist firms can be seen as a power relationship, or at least one of relative strength, because some firms are in a superior competitive position to others, e.g. because they have lower costs.[i] This drives the evolution of market structure.

A further form of power, buying power, is the focus of this paper: the degree of influence that arises from the amount of money that an individual possesses, whatever its source. It is similar to income and wealth, indeed these are the source of buying power, but in terms of their *causal impact on the economy* rather than on the wellbeing or utility of individuals. Poverty, wealth and inequality are not just outcomes, they also have knock-on causal effects: circular flow describes this, and is a well-known concept in economics, but its importance tends to get lost in certain contexts. This will be outlined for the context of capitalism and the current situation, but it should be noted that it also applies in non-capitalist settings, for example in the context of debt bondage, and in relation to famines (of which more below).

The wide distribution of disposable income in present-day society means that people have differing levels of ability to afford what they want. This is so obvious that it is almost embarrassing to state it. It is one of the things that "everybody knows" about the economy. Yet it is not explicitly mentioned in current standard economic theory, e.g. as set out in textbooks. It is different in this respect from e.g. "market power", which does have an established place. I will briefly set out some ways in which the concept of buying power is used in practice; then review how it appears in the work of some important economists, albeit not necessarily under this name, and how it disappears in the basic account of consumer theory. I then review the effects of differential buying power on consumption, asset ownership and the environment – the triple crisis – and end by suggesting that a fourth crisis is preventing effective action to address these.

"Buying power" in practical use

The concept of buying power (or equivalently, purchasing power) is indispensable in thinking about the economic world, and is commonly encountered in substantive, concrete descriptions of events in the economy, e.g. journalistic accounts. It is also widely used in relation to inflation, in comparing the purchasing power of a unit of money at different time periods – it appears with this meaning in e.g. Irving Fisher's "The purchasing power of money"[ii] – but not in the sense of the different relative strength of individuals. In addition, "purchasing power" is used in practical situations, for example in finance, to indicate the sum available for investment.

One example of its practical descriptive use can be found in an ethnic comparison. The Selig Center for Economic Growth has produced estimates of the buying power – the after-tax income, neglecting saving and borrowing – of each ethnic group in the USA.[iii] For example, the buying power of African Americans grew from $316 billion in 1990 to $600 billion in 2000, and to $947 billion in 2010. This growth is attributed to an increase in the number of blacks who are starting and expanding their own businesses (as well as to population growth and inflation), based on US Census Bureau data. Moreover, the report states that blacks spend proportionately more than the national average on phone services, utilities, groceries and footwear, but less on used cars, alcohol, health care, entertainment and pensions. Similar figures are provided for Asians and Hispanics.

The related phrase "buyer power" has also been used to refer to the differential power within the retail sector. It is seen as "arising from the ability of leading retail firms to obtain from suppliers more favourable terms than those available to other buyers, or which would be expected under normal competitive conditions", in a report on the situation in Europe.[iv] The report documents the large and growing degree of concentration in the European retail sector, "raising the prospect that such large firms may be able to command market power over suppliers and consumers alike and earn super-normal profits as a result".

"Buying power" in the works of key economists

Adam Smith was well aware of the importance of buying power, as in his famous observation that having money gives one the ability to "command" the labour of others.[v] It is therefore to some extent power over other people, as long as they are willing to trade their labour or goods. In addition, his central concept of "the size of the market" indicates not only the *number* of people, but also their *ability* to afford to buy goods and services. For a particular product, there is the third element of the extent to which people wish or *choose* to purchase it, but still the question of ability to do so – *effective* demand – remains fundamental.

Again, the central idea in Keynes' economics is aggregate demand, the buying power of the whole economy.[vi] This concept is alive and well in macroeconomics, but only at the aggregate level. It needs to correspond with an equivalent at micro level – whatever one's views on micro-foundations, and on the best method of relating micro-level and aggregate concepts. However, as an aggregate-level concept it does not convey the importance of individual-level differences in buying power.

Circular flow is one concept in economics in which buying power plays an integral role. Schumpeter in particular used this phrase to denote an unchanging economy, a calm world of no change, to contrast with his vivid descriptive account of "creative destruction".[vii] If it is static in this sense, it does at least highlight the flow from income into spending, so one aspect of the movement of money in the economy is captured. In principle, "circular flow" would be a way of incorporating the availability, and specifically the *variations*, of buying power into an analysis. Traditionally, however, it has been used in a far more limited way, and shares the characteristic of aggregate demand that individual variations are ignored.

There is, however, one particular context in which something very like buying power has been used in economic analysis at the micro level: Sen's concept of entitlements. It is an essential feature of his work on famines, in which he showed that "starvation depends 'not merely' on food supply but also on its 'distribution'"; the same idea explicitly applies to poverty more generally.[viii] He analysed the ability of people living in very different circumstances to obtain food, in terms of their entitlements to the food that they eat – and on how this can sometimes mean that they have none. Their entitlements could be by virtue of production by their own labour, of exchange for another good that they already own, of access to land, etc. It is an analysis of the social arrangements that underlie the differential ability of e.g. landless rural labourers, sharecroppers and peasants to feed themselves and their families, and how this varies with factors such as rising food prices. In an economy dominated by markets, this would mainly operate through entitlements expressed in monetary terms, which is essentially the same as buying power. My contention is that this approach needs to be extended beyond famines and absolute poverty, to inequalities more broadly.

"Buying power" in economic theory

Much of this is well recognised, even if it is not part of economic theory. Does this omission matter? Yes it does, because if as economists we grasp some important aspects of reality in a practical and/or intuitive way, but they are absent from theory, then we are prevented from seeing the incompleteness of the theory. It protects inadequate theory.

Indeed, it is obvious that people differ in their buying power, and that this is important to how the economy operates. But then how is it represented in microeconomics? In consumer theory it is represented by a fixed budget constraint, in other words it ceases to play an active part. This may well be justified in certain circumstances, *for modelling*; it should then be seen as a special limiting case. But *as a description of how the economy works*, it means that economics is confined to being a type of decision theory, rather than a quantitative account of the actual flows that occur in the economy. Demand becomes seen as a matter purely of choice, and not in terms of *effective* demand.

Another way of expressing this is, there is a tendency in some parts of economics for the degree of prosperity to be seen as an outcome but not a cause. In consumer theory, the lack of input of buying power and its variation means that it is taken as given, it merely has the role of an exogenous factor. More broadly, an individual's existing endowments are taken as one type of determining factor, along with preferences and technology. Whether the latter two concepts should be treated as always and necessarily exogenous is a separate issue – but surely buying power is an essential part of the subject matter of economics? To exclude it renders any account static, in a different sense from that of Schumpeter's circular flow, that the system being analysed is cut off from any inward flow.

I now examine the consequences of bringing in the logic of circular flow, and including this missing link, from income into spending.

Effects of differential buying power

Consumption

A higher level of buying power enables the possessor to purchase a larger quantity of goods and services, and of higher quality. This affects what is produced: the "vote" that influences production is proportional to buying power. A particularly important aspect of this is the way that economic inequality affects the types of goods and services that are available, because richer people tend to prefer luxury items. They also can afford luxury housing, and leisure pursuits such as golf courses, thereby bringing about often-irreversible changes in land use. Hotels take over stretches of beach that were previously accessible to the local population. In addition, buying power can lead to displacement of people, even in a very distant part of the world: e.g. the demand for prawns in the rich world has led to the eviction of low-income people in parts of coastal Southeast Asia, to make way for prawn farms. These examples demonstrate the importance of seeing the varying degree of buying power across the population not only as outcome, but also as input.

Asset ownership

Buying power is important not only as an attribute of consumers. The capitalist firm is typically managed by a relatively small group of people, who make the decisions and take the initiatives that determine the degree of success of the firm. But ownership of the stock depends on buying power, so shareholders can benefit from the success of a firm even when their only contribution has been to buy its stock. Thus the relatively rich can use their buying power to multiply it further, although admittedly they also are risking their money in this instance – an aspect that has led to the shareholder primacy argument.[ix,x] (This view gives primacy to buying power over decision making, which is the mirror image of the micro theory on consumption that focuses on decision making to the exclusion of buying power.)

In the financial sector too, buying power is central. Debt is the temporary transfer of buying power to those who do not currently have it, typically from those who have it in abundance, thus accentuating the gap between them when it needs to be repaid with interest. This is a power issue, just as in the non-capitalist context of debt bondage, in which poor peasants are at the mercy of rich lenders: they get into this position because of their lack of income and therefore of buying power, and debt exacerbates this. The well-documented decline in the share of wages, e.g. in the

United States since the 1970s, together with the accumulation of capital in financial institutions, has led to private-sector debt ballooning to an enormous extent, which has not only led to greatly increasing economic inequality but also to financial instability.[xi]

A further aspect of the role of buying power is the tendency for capital, and property more generally, to reproduce itself. Ability to purchase capital means the ability to derive a corresponding rate of return. This is part of a far more general phenomenon, the reproduction of advantage, which is manifest as a power law in such diverse fields as city sizes,[xii] academic citations[xiii] and firm size,[xiv] as well as income and wealth.[xv]

Environmental consequences

The buying power of firms – as contrasted with the buying power of the shareholders who jointly own them – gives them the power to transform the world, e.g. by taking possession of land and other natural resources. To a large extent, the modern world has been created by the actions of firms, including real estate firms, transforming the surface of the Earth. They are using their buying power in order to increase it.

However, the environmental implications of buying power are not confined to the actions of capitalist firms. Individual consumers who have buying power are using it to satisfy their own wants, with environmental consequences that depend on the way that it is used. For example, car owners and meat eaters are contributing to various types of environmental damage, including greenhouse gas emissions. It is a question of the distribution of environmental footprint; and in particular of excess footprint per person among the rich. Buying power enables consumers to command not only the labour of others, as Smith said, but also to influence what is produced. They – we – are commanding resources the world doesn't have.

Conclusion: the fourth crisis

Buying power then is a form of economic power, helping to shape what a particular economy consists of and how it changes over time. Conversely, lack of buying power implies a lack of influence, and in extreme cases a lack of subsistence too, as in Sen's work on famines.

But in fact there is a fourth crisis that underlies the other three, and prevents action to redress these problems (except one on excess footprint among the relatively rich). Going beyond pure economics into political economy, a large amount of buying power means the ability to influence people. This is seen in advertising; and in lobbying, ownership of media outlets, think tanks, political influence. It translates into a broader form of power or influence, helping to shape what a particular society consists of and how it changes or fails to change. The rich have captured the political process in many countries, which have become plutocracies in which possible policy directions that could address the triple crisis are ruled out because they conflict with the vested interests of the rich and powerful. Whether it is financial-sector and corporate lobbying for deregulation and tax changes leading to instability and hugely increasing inequality, or the oil and gas industry and its allies blocking effective action on climate change, the political reach of those with disproportionately large buying power – “deep pockets” – means that there is actually a quadruple crisis.

---

[i] Joffe M. The root cause of economic growth under capitalism. Cambridge Journal of Economics 2011; 35: 873-96.
[ii] Fisher I. *The purchasing power of money*. Macmillan, 1912 (& 1922).
[iii] Humphreys JM. *The Multicultural Economy 2012*. The University of Georgia Terry College of Business – Selig Center for Economic Growth: http://www.nmsdc.org/nmsdc/app/template/contentMgmt,ContentPage.vm/contentid/2168;jsessionid=119771F9713544756CF81B106987FF4C#.U0vsvvldWSp
[iv] Dobson P, Clarke R, Davies S, Waterson M. Buyer power and its impact on competition in the food retail distribution sector of the European Union. Journal of Industry, Competition and Trade 2001; 1(3): 247-81.
[v] Smith A. *An inquiry into the nature and causes of the wealth of nations*. 1776.
[vi] Keynes JM. *The general theory of employment, interest and money*. London: Macmillan, 1936.
[vii] Schumpeter JA. *The theory of economic development*. Translated by Redvers Opie. Cambridge, MA: Harvard University Press, 1934.
[viii] Sen A. *Poverty and famines: an essay on entitlement and deprivation*. Oxford: Oxford University Press, 1981.
[ix] Jensen MC, Meckling WH. Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. Journal of Financial Economics 1976; 3: 305-60.
[x] Stout LA. Bad and not-so-bad arguments for shareholder primacy. Southern California Law Review. 2002; 75: 1189-209.
[xi] Piketty T. *Capital in the twenty-first century*. Translated by A Goldhammer. Cambridge, MA: Harvard University Press, 2014.
[xii] Gabaix X. Zipf’s law for cities: an explanation. Quarterly Journal of Economics 1999; 114: 739-67.
[xiii] Merton RK. The Matthew effect in science. Science 1968; 159: 56-63.
[xiv] Gabaix X. Power laws in economics and finance. Annual Review of Economics 2009; 1: 255-93.
[xv] Piketty, *op cit*.