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The Neglect of Buying Power in Traditional Economic Theory, and its Practical Implications

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Abstract Buying power, the causal consequence of income and wealth, is ubiquitous in the real world, but not prominent in economic theory. Its importance can be seen e.g. in the relative power of rich and poor consumers, the effective demand that supports each industry, the power that firms have to build their premises and to exercise authority over their workers, the influence of shareholders over firms, and in international economic relationships. Adam Smith remarked that having money gives one the ability to "command" the labour of others, and Keynes based *The General Theory* on the concept of aggregate demand, but buying power is seldom recognised when analysing the detailed working of the economy – the main focus is on willingness, not ability, to pay. An important exception is Sen's work on famines and entitlements. The source of buying power for individuals is income/wealth, and also transfers and borrowing. For firms, buying power derives from profit, and also from a promising investment plan. Buying power is an essential concept not only for understanding how the economy works, but also because it is central to three important practical modern problems: inequality and its consequences, including displacement; debt and financial instability; and environmental degradation.

Keywords Buying Power, Economic Power, Effective Demand, Aggregate Demand, Entitlements, Inequality, Financial Instability, Environmental Degradation

1. Power and Economics

Traditionally, economics has not been much concerned with power, apart from specific types such as monopoly power. This paper explores a particular source of power, which can variously be termed "buying power", "purchasing power" or "purchasing capacity". The term "power" here, and throughout this paper, primarily denotes the ability to bring about some course of action in the economy, i.e. it is *causal*.

1.1. Buying Power

Buying power is 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 main sources 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 consequences: circular flow describes this, and is a well-known concept in economics, but its importance tends to get lost in certain contexts. The main focus of this paper will be on the context of capitalism and the current situation, but it should be noted that buying power is also important in non-capitalist settings, for example in the context of debt bondage in a peasant society, and in relation to famines (of which more below).

Buying power is the ability to generate a flow of money. In a transaction, either buying or earning, it is expressed as a flow. The same is true of a transfer, whether within the household or mediated by the state or a charity or bequest. Flows can also accumulate into stocks, and the two have the same relationship as income has to wealth.

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.

In this paper, I give some examples of buying power in the economy. I then briefly set out some ways in which the concept of buying power is used in practice. I also 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 three types of effect of differential buying power. First, its impact on consumption is central to socioeconomic inequalities, a topic of increasing concern across the political spectrum. Secondly, the effect of differential buying power on asset ownership has brought about increasing systemic instability. Thirdly, buying power – and specifically abundant buying power, mainly in the rich parts of the world – is having a dramatic impact on the environment.

1.2. Some Examples of Buying Power

Examples are everywhere. In pleasant locations, affluent urban dwellers buy holiday homes, thereby crowding out the local inhabitants, who do not have the buying power to compete, and therefore may have to leave the area.

In low-income countries, and possibly elsewhere too, the prevalence of transactional sex is related to the degree of inequality but not to the degree of overall poverty [1, 2]. The women have low incomes in both situations, but the difference is the buying power of men – relatively high with inequality, but low with overall poverty.

Any purchasing decision depends not only on choice, as emphasised in economic theory, but also on the *ability* to pay, i.e. the availability of buying power. Not everyone can afford a washing machine. And the washing machine industry is viable because there are enough people with the buying power to provide a large enough market. Luxury goods such as mega-yachts and private jets exist because there are rich people to buy them. Spending power is "voting" power in the market.

This does not only apply at the level of individuals. The buying power of firms gives them the ability to transform the world. They have the resources to take possession of land, to build whatever they wish (subject to planning regulations), etc. Buying power operates within firms too: the hallmark of the firm, which distinguishes it from the market, is its authority structure – the ability of someone in authority to assign tasks to a subordinate, to allow them access to certain of the firm's resources (e.g. a machine) [3], to be responsible for their work, and to have some influence at least over their career prospects, e.g. their promotion or dismissal. Subordinates accept this because the firm has the buying power to be able to pay their wages; to be a "going concern", a firm needs to be able to meet its wage bill as well as other costs.

Buying power is important not only as an attribute of consumers. The capitalist firm is typically set up by an entrepreneur, who does not necessarily have their own capital, and the direction taken by an already-existing firm depends on its directors, who make the decisions and take the initiatives. The firm's subsequent degree of success depends on the quality of their decisions – their "managerial capacity" [4], as well as on luck. In contrast, ownership of the firm's stock depends on the buying power of shareholders, who 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 [5, 6]. This view gives primacy to buying power over decision making, treating shareholders as "principals" and directors (usually described merely as managers, with the implication that they can readily be hired and fired) as their "agents". This is the mirror image of the micro theory on consumption that focuses on decision making to the exclusion of buying power.

Buying power also has macro and international consequences. When Chinese industry was booming, it led to a massive demand for commodities throughout the world – Brazil, Australia, Sub-Saharan Africa – so that their prices and quantities rose. When China became less dynamic, that subsided.

1.3. The Phrase "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" [7] – 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 [8]. 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 black people who are starting and expanding their own businesses (as well as to population growth and inflation), based on US Census Bureau data.

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 favorable terms than those available to other buyers, or which would be expected under normal competitive conditions", in a report on the situation in Europe [9]. 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".

2. "Buying Power" in Economics

2.1. "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 [10]. 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 [11]. This concept is alive and well in macroeconomics, but only at the aggregate level. At most, the economy is disaggregated into sectors, as in stock-flow consistent modeling [12]. 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, or even socioeconomic inequalities, 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" [13]. Although 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 and socioeconomic inequalities 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 [14]. 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 such factors as rising food prices. In the different context of 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 the way that wealth and income, and especially *inequalities* in wealth and income, affect not only the economic wellbeing of those involved, but also the economy more broadly.[1]

2.2. "Buying power" in Standard Microeconomic Theory

The standard account of the price mechanism stresses its ability to bring supply and demand into alignment, which is an important property. Everybody knows that when the price rises, not only is there a fall in demand because potential buyers choose not to go ahead with their purchase, but also some potential buyers may drop out altogether because they cannot afford the higher price. They are excluded. It is a form of rationing based on the ability to pay. Yet the standard textbook description dwells on the willingness not the ability to pay.

Much of this is well recognised, even if it is not part of standard 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 demand becomes seen as a matter purely of choice, and not in terms of *effective* demand. Economics of this type then becomes confined to being a type of decision theory, something concerned with behaviour, rather than a quantitative account of the actual two-way flows that occur in the economy.

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, whereas it is of course both. 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. This is part of a wider tendency for economic phenomena to be seen as determined by factors outside the economy: endowments, preferences and technology – because the economy is conceptualised as an optimised and therefore automatic process. Whether preferences and technology should be treated as 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.

2.3. The Source of Buying Power

A focus on circular flow would have a further benefit.

1 By using analogous reasoning, it is clear that the source of *buying power* is distinct from the source of the *money*.

Consumers and workers are often treated as if they were different people. In fact they are roles, and most people are at some time in their lives both workers and consumers. But in addition, the circular flow perspective makes it clear that they are closely related: consumers – and the magnitude of their buying power – depend on their incomes as workers, either directly or via transfers. Employment is the *origin* of most individuals' buying power. An alternative source is return on capital, e.g. from real estate or from financial assets.

The situation is somewhat different for firms and for the state. Firms derive their buying power from their previous profits (excess of revenue over expenditure), in an analogous way to the income of individuals. This is their *ex post* source. In addition, they have an *ex ante* source: the core of the capitalist real economy is the ability of firms to invest. An investment starts as an idea, a strategy – typically expressed as a business plan – that exists before any money is spent on it. Even if no *ex post* funding is available from retained profits (or from individual wealth), the promise of future profit enables the firm to attract external funding. At this stage, it is unknowable whether the profit will be realised at a later date – this is subject to radical uncertainty. But it still enables the firm to take on commitments, including to hire staff and to direct their activities as described earlier.

In an analogous fashion, the state derives its buying power from revenue, primarily taxation but also sometimes profit on state-owned enterprises, and from its ability to borrow.

Buying power can also be amplified by the transformation of production in a sector that one does not directly participate in. Over a period of time, the competition between firms tends to lead to lower unit costs, and thence to a fall in the price [15]. Purchasers do not need to spend as much to obtain the same as before, and so this effectively raises their buying power. Over time, the real price of a large number of goods and services has fallen, e.g. when measured in terms of the number of minutes of work required to purchase them [16].

3. Conclusion: The Consequences of Differential Buying Power

3.1. Inequalities in 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 roughly 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, with further consequences such as the squandering of scarce water in arid regions such as southern Portugal. Hotels take over stretches of beach that were previously accessible to the local population.

At the other end of the scale of income and wealth, individuals and households with low income have less discretion over their expenditure: more has to be spent on necessities. As Engel established empirically in 1857, the poorer a family is, the larger the budget share it spends on nourishment [17]. The implication is that low-income households contribute buying power to those necessities, albeit to a limited extent given the overall low income level, but little to other goods and services. The nature of necessities also implies that there is less discretion in spending, and therefore less control over the destination of the buying power – which is the reason why the concept of *disposable* income is useful.

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 – where consumers have abundant buying power – 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 with important economic consequences.

3.2. Asset Ownership and Systemic Instability

Buying power is central in the financial sector. 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 led to greatly increasing economic inequality [18]. This inequality in turn encourages further borrowing, as people seek to maintain their living standards. The resulting vicious cycle (reinforcing or positive feedback loop) has led to a ballooning of debt in many societies, and thus to financial instability and crisis.

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 (sometimes known as the "Matthew effect"), which is manifest as a highly-skewed distribution – a power law – in such diverse fields as city sizes [19], academic citations [20] and firm size [21], as well as income and wealth [18].

3.3. Environmental Consequences

The buying power of firms – as contrasted with the buying power of their shareholders – 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 users and meat eaters contribute to various types of environmental damage, including greenhouse gas emissions. It is a question of the distribution of ecological 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 command natural resources. They – we – are commanding resources the world doesn't have.

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