A rational view of the economy

The pandemic seems to have opened up the opportunity to discuss some fundamental issues about how our society works, and many are asking, who for. Perhaps, perhaps that allows some room to question the gargantuan machine that is the backdrop to all our lives. Of course, it's the economy stupid!

No-one knows for sure but we think money was invented around 5000 BCE. Does that mean there was no 'economy' before then? Of course not. As soon as people traded anything with other people instead of making a living from hunting and gathering, economics was born. Much of this was, and remains, un-monetised (e.g. family caring) and so is not represented quantitatively in the national accounts. However, this activity is still 'economic' in the broader sense of the word. People were, and are still, using their labour in return for something, whether for altruistic or selfish reasons. Traditional tribal life was about shared labour for survival and a decent life and yes, it still involved (albeit in mini-scale) mining, agriculture, construction and services. Some of the fruits of that labour was traded with other folk when this was seen as mutually beneficial. The modern economy is exactly the same and for the same reason, i.e. shared labour for survival and a decent life, and mutually beneficial trade. The fact that most of us in the modern world have moved up Maslow's hierarchy to some extent, does not mean we don't rely on the basic needs of food, shelter and safety.

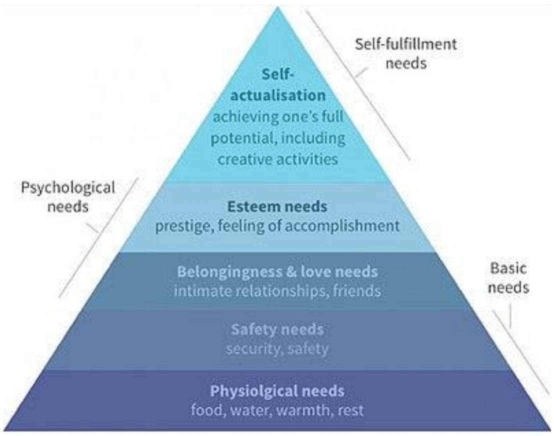

Figure 1 Maslow's hierarchy of needs (Wikipedia)

So, the essence of the economy is not about the volumes of money exchanged each year as measured by Gross Domestic Product (GDP), it is about human interactions for the purpose of achieving wellbeing, a decent quality of life. And sustainability is about retaining that decent quality of life into the future, i.e. 'enduring wellbeing'.

The core component of GDP is 'consumption', which measures the expenditure of 'households' over a year. Although you wouldn't know if from reading the financial press, households comprise "citizens" rather than workers, managers, shareholders or politicians. We are all householders when we get home from work. In most modern economies, consumption is over half of GDP when measured by expenditure. When measured by income, wages and salaries earned by households are also around half. In fact, household income and expenditure really represent the whole economy if we think about it clearly. The other components of GDP by expenditure are: business investment, government spending and net exports (exports minus imports). Let's take these one at a time.

The role of businesses is to provide households with the goods and services that contribute one way or another to the hierarchy of needs. Of course, many businesses do not supply their products directly to households. We do not directly buy the products from BHP's mining activities. However, we do buy the end result of those raw materials when they are converted through manufacturing to household goods like refrigerators and cars. BHP's sales to their customers are not directly counted in the national accounts. They are treated as intermediate transactions, i.e. they are embodied in the eventual sales of goods and services to households. All business sales are therefore paid for by households, either directly or indirectly.

Before they have products or services to sell to anyone, businesses need to invest in (and replace) physical assets such as property, buildings, industrial plant, technology, or equipment. This is also expenditure and so it is counted in the national accounts. However, you can think of business investment merely as a cost incurred before a sale. As all eventual sales are to households, these investment costs are just yet-to-be-incurred expenditure by households.

Governments also spend money on a variety of things, including investment in infrastructure and household services like health and education. However, the money for this comes from taxation of households and businesses. Taxes are merely an additional cost to business and so are reflected in their charges (directly or indirectly) to households. The benefits of infrastructure (roads, hospitals, water supply) flow either directly to households or indirectly via businesses. One way or the other households supply all taxes to governments, and receive a bundle of goods and services in return.

Lastly, let's think about imports and exports. GDP measures net exports (i.e. exports less imports). Imports result from expenditure either directly by households (e.g. Amazon) or indirectly via businesses who pass on the costs to their customers, and hence eventually to households. Exports merely supply goods and services to households in other countries, again either directly in the form of final products or indirectly through businesses in other countries.

So, essentially all GDP expenditure accrues to households directly or indirectly, but not necessarily all in the year the transactions are counted, and not all in the same country.

What about GDP as measured by income, which of course (approximately) equals expenditure? This is largely a measure of wages and salaries (which go to households) and profits (along with interest, rent and a few other ancillaries). A company's profits represent the money left over after paying the costs of the goods and services they have purchased as inputs, plus wages, taxes and dividends to their shareholders. This is a zero sum game. The money goes either to the company in profits (meaning its shareholders) or to wages. More to one means less to the other. Of course, lower profits would also mean lower corporate tax. However, if that money went to wages instead of profits, the government would receive higher levels of income tax. Profits and dividends are nothing more than a diversion of income from wages.

However, of course, profits are absolutely necessary to retain business viability, which is just as critical for employees as business owners (as amply demonstrated during this Coronavirus crisis). 'Retained earnings' are used to both ensure adequate cash flow and to re-invest in the business. The issue is not whether profits per se are necessary or not. The question is whether "excessive" profits are beneficial to the households that produce them. The ratio of profit to cost that is reasonably necessary to run and grow a viable business varies dramatically, depending on the nature and scale of the business. Let's say we could assess what is a "reasonable" level of profit across the economy. The residual "unreasonable" profit could have otherwise been paid in wages, or never made in the first place by reducing charges to customers. As noted above, charges to customers eventually end up as costs to households one way or the other. Whether due to lost wages or higher costs, households bear the brunt of excessive profits. Given the level of income inequality in Australia[1], a redistribution that benefitted lower income households by lowering their costs and / or increasing their incomes would obviously be good economic policy. That is, if you accept that the purpose of the economy is to support the quality of life of households, i.e. citizens.

What would be lost through a reduction in excessive profits? The money needed for investment in businesses? Perhaps, but most firms use borrowings and new equity to finance new investment, not just retained profits. If money was diverted from profit to wages then the amount of money in the already huge and rapidly growing superannuation business would increase. What do fund managers do with this money? They invest it (inter alia) in businesses by buying shares, property and bonds. In other words, increased wages are an alternative route to business investment. The Australian superannuation funds under management are currently $3 trillion which is about 8 times the amount of money invested in physical assets in Australia by the private sector in 2018-19[2]. Deloitte forecasts that will increase to $9.5 trillion by 2035.

This gives households / citizens financial power to influence where investment from our superannuation holdings goes, and this has the potential to reshape the world. Or it would, if investment fund managers were required to be responsive to the interests of the investors. Richard Denniss has recently reminded us[3] that they aren't but could be.

"Anyone who says there is nothing we can do to change the way big business operates doesn't understand how big our superannuation funds have become. Our funds own big business and our funds are supposed to work for us. We just have to find a way to put our voice where our money is."

Imagine the power of citizenry investments to better align business to social needs, including towards the direct factors that affect our present health and wellbeing (like hospitals and education), and the indirect ones that affect our future wellbeing (like climate change and biodiversity loss).

The Coronavirus pandemic has shown us what really matters – the health and wellbeing of ourselves, our family and friends. The economy is there to serve us as citizens not as consumers, and its goal should be to get us collectively as far up the Maslow hierarchy as we can go with the resources we have. As it is entirely dependent on us, we should take the reins and direct it towards that goal. We can do so by choosing how we live, what we buy, what (not who) we vote for, and where we invest our time and money. Making this happen should be the next major step on the stop-start journey to democracy, which is by the way, a pre-condition for sustainability.

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[1] "In Australia, someone on the highest 1% of income earns more in a fortnight than someone in the lowest 5% earns in an entire year. To put it another way, someone in the highest 20% of the income scale lives in a household with five times as much income as someone in the lowest 20% of the income scale." http://povertyandinequality.acoss.org.au/inequality/

[2] https://www.ceicdata.com/en/australia/sna08-gross-domestic-product-by-expenditure-current-price?page=2

[3] https://www.themonthly.com.au/issue/2020/april/1585659600/richard-denniss/super-heroes-or-super-villains