

July 29, 2019

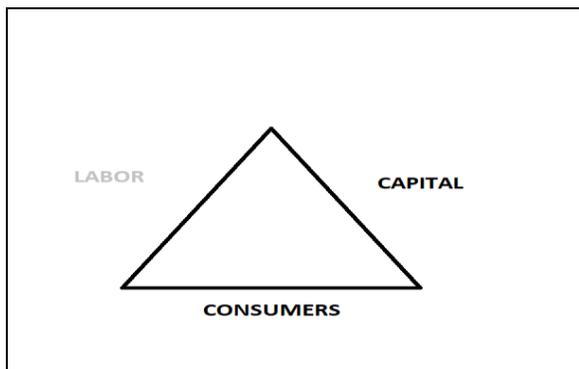
## **The Economic Triangle: Part II**

Last week, we referenced the basic philosophies of David Hume and Adam Smith and how their writings evolved into the economic theory of supply and demand. From there, we examined the weakness of supply and demand at the macro level and discussed an alternative model, the Economic Triangle, as a different means of explaining how various economic participants operate and the way in which political factors affect the triangle. This week, we will show how the Economic Triangle fits into the major economic systems, offer two contemporary examples and conclude with market ramifications.

### **The Theories**

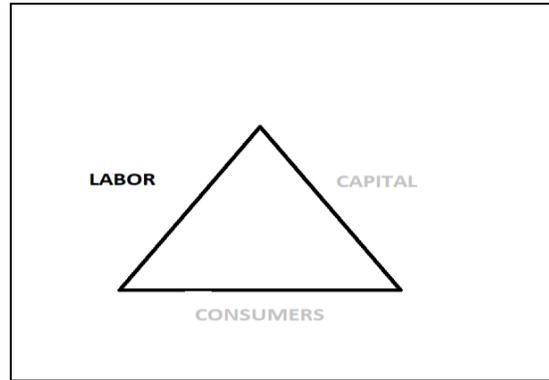
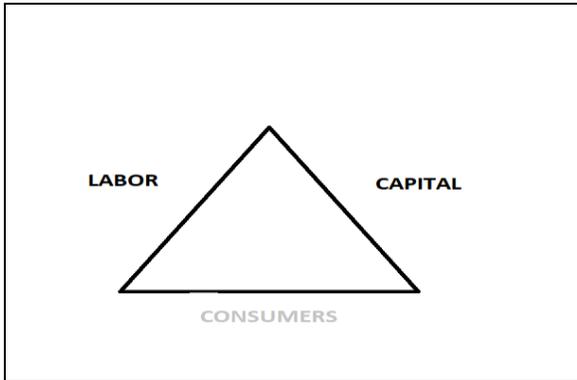
The history of economic thought and political economics has generated a plethora of theories and paradigms for balancing these interests. Here are some of the important ones:

**Traditional capitalism:** In practice, it tends to favor capital first and consumers second.



Capital is privately owned. Government interaction in the economy is limited to internal and external security and enforcing contracts. The central idea is that markets bring the optimal allocation of goods and services with minimal government intervention. The markets are thought to be self-correcting and do not rely on government intervention to address imbalances. This model would support globalization and deregulation as the expression of private decisions. The primary advantage of this model is that capital allocation tends to be more efficient under conditions of competition. In other words, the collective wisdom of the market (Smith's "invisible hand") leads to the best outcome for capital creation and maintenance. For this advantage to work, misallocated capital investment must be punished by the marketplace in order to discipline investors. Profitability is the most important test for the suitability and success of investment. Because capital is controlled privately, technological change can occur rapidly. The primary weakness of the model is that over time capital tends to become overly powerful and dominates the other two legs of the triangle. Not only does the domination affect the political system but it can also foster malinvestment because large firms can absorb investment mistakes more readily. Although consumers tend to benefit in this model (there is usually a plethora of goods and services at favorable prices), those mostly compensated by wages tend to be disadvantaged.

**Socialism:** Under socialism, capital is mostly held by the state.

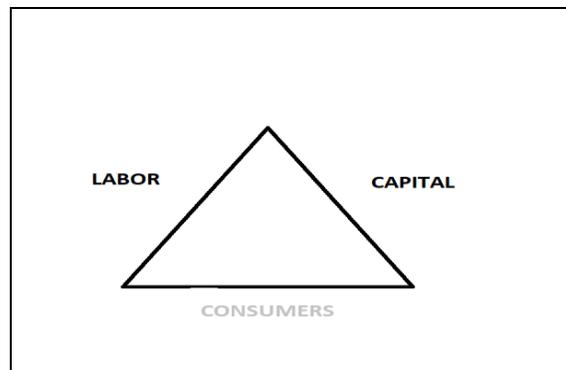


Historically, there have been numerous variants of this model; in some, all capital is state-controlled, while in others only the “commanding heights” of the economy, the most critical industries, are held publicly. The primary strength of the model is that it mitigates the political power of capital through social ownership. The primary weakness of the model is capital inefficiency. Since the costs of investment are borne by society at large, the potential for mistake is greater because those making the errors are rarely penalized. Profitability is not the sole determinant of the success or suitability of investment. In addition, because of the disruptive nature of new technology to labor, change tends to occur slowly. Socialist economies often trend toward stasis. In this model, labor tends to be favored. Capital is less favored; however, history shows that the political class usually ends up controlling capital so the government will tend to prevent that part of the triangle from being overly constrained. Consumers tend to suffer most under this model. They often do not receive the benefits of new technology and the bias of government leaders is to support labor and capital. Consumer goods are often scarce and the variety of goods and services can be restricted.

**Communism:** Communism in its purest form has full ownership of capital and purports to foster the domination of labor.

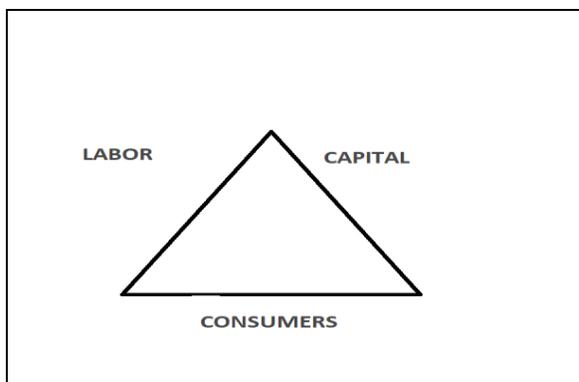
Thus, capital and consumers are both disadvantaged. In practice, state ownership of capital leads to outcomes similar to socialism, where capital and labor are favored against consumers. In the early years of the Soviet Union, the leadership disadvantaged capital and essentially consumed whatever capital stock remained after the fall of the Tsar. This capital consumption eventually undermined economic growth. Under Stalin, the industrial base was rebuilt and expanded by forcing consumers to save through the scarcity of consumer goods. From that point forward, the difference between communism and socialism, at least from an economic standpoint, diminished. Capital allocation decisions are made solely by the government and profitability is usually not a factor.

**Fascism, or state capitalism:** Fascism is more of a political model than an economic one. Nevertheless, in practice, fascist states do tend to follow a path that can best be described as right-wing socialism.



Capital usually remains in private hands but is “guided” to specific state goals. Firms are often allowed to concentrate to a large scale. Capital owners realize they have less than complete control over their capital assets and profitability isn’t necessarily supported. Labor tends to be favored over consumers, but the former is disadvantaged relative to capital. Germany and Italy followed this model in the run-up to WWII. It could be argued that Japan, South Korea and Taiwan also followed this model in the initial stages of their development, although they have become more similar to traditional capitalism as they industrialized.

**Mixed capitalism:** Although Keynesian economics is the most common variant of this model, other models do also exist. The essential characteristic of this prototype is similar to traditional capitalism but has a larger role for the state.



Often, government has a broader regulatory role in the economy but, most critically, policymakers are expected to play an active role in guiding the economy. Capital usually remains in private hands but is constrained, to a greater or lesser degree, by government. Labor and consumers tend to be favored at various times. Perhaps one of the more interesting features of this model is that it tends to favor capital in all situations but to varying degrees. Labor is sometimes

favored against consumers, while consumers are favored against labor in other periods.

These are the essential models that have been deployed throughout history. In terms of the power structure of any society, the Economic Triangle creates a structure for analyzing how a society will favor or disfavor the three groups. This isn’t to say that supply and demand should be jettisoned. It still has great power because it can signal the interaction of price and quantity. However, because it combines labor and capital on the supply side of the economy, our concern is that it may understate the level of conflict that can exist between the two.

### Using the Economic Triangle

In this section, we will discuss a couple ways the Economic Triangle can be used to analyze contemporary economic and political situations.

The first is China’s need to adjust its economy. Although China is run by the Communist Party of China (CPC), it does not operate its economy based on Marxist principles. Instead, it has mostly adopted a moderate socialist model. Beijing dominates the economy through its state-owned enterprises but does allow a significant level of private ownership of capital. In the Chinese development model, capital was heavily favored. Both labor and consumers were disadvantaged as the CPC used export-promotion for development.

China has now reached a level of development where this model is no longer appropriate. It needs to adjust by favoring consumers to replace foreign demand with domestic demand. This may require a downgrade in the status of capital or a simultaneous lift for labor. However, there is an alternative in which the ownership of

state-owned enterprises could be shifted to households to increase their wealth and boost spending by further favoring capital ownership.

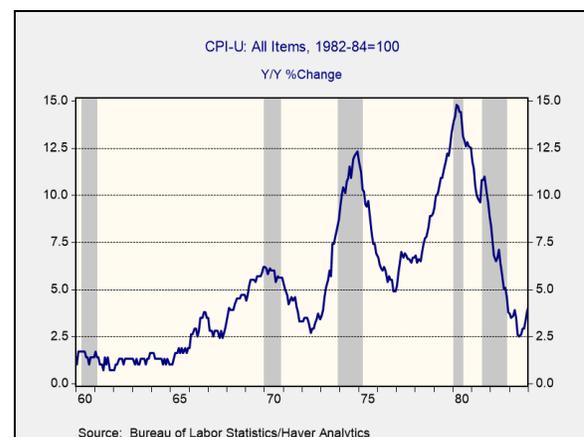
In any case, the CPC must reduce the position of the current owners of capital, whether they be private owners or the state. This would occur either by dilution (the selling or granting of shares to households) or restructuring (reducing the power of capital by allowing labor and consumers more power). Anytime a party that currently enjoys power is “asked” to relinquish some of it, there is usually resistance. Chairman Xi has engaged in an aggressive anti-corruption campaign which could be a way of intimidating current capital holders into deciding that cooperation is a better option.

So, when using the Triangle, capital needs to see its position degraded with either labor or consumers elevated. But, so far, there is scant evidence that this is occurring. The Soviets faced a similar problem in the 1950s and 1960s. Economic growth in the Soviet Union had markedly improved, so much so that Soviet leader Nikita Khrushchev once suggested that “[we will bury you](#)” when expressing the belief that communism was a superior economic model and would eventually overwhelm the capitalist world. However, the Soviets were never able to shift from favoring capital and labor to advantaging consumers and their economy stagnated.

China needs to reduce the power of capital holders. However, those in power are often high-ranking members of the CPC and therefore would have to willingly acquiesce to reduce their wealth and status. If Chairman Xi eventually makes this shift, it would create conditions where growth would fall to a sustainable level and the financial system could deal with its rising

debt problem. But, changing power relationships is difficult.

The second example is the equality/efficiency tradeoff. Arthur Okun wrote a seminal work in which he postulated that there is a tradeoff between equality and efficiency.<sup>1</sup> Essentially, if a society wants greater equality, it needs to tolerate less efficiency. If a society wants more efficiency, the cost is inequality. The Economic Triangle is a useful tool in analyzing this tradeoff. During the last equality cycle, which we estimate ran from 1932 to 1978, U.S. policymakers engaged in policies that favored capital and labor at the expense of consumers. Perhaps the best description of this period was from John Kenneth Galbraith.<sup>2</sup> In his book, *The New Industrial State*, he described a mixed economy that was controlled by the interaction of large labor unions and concentrated industrial firms overseen by the government. Consumers had little voice in the economy. The result was a steady rise in inflation that eventually led to a crisis.



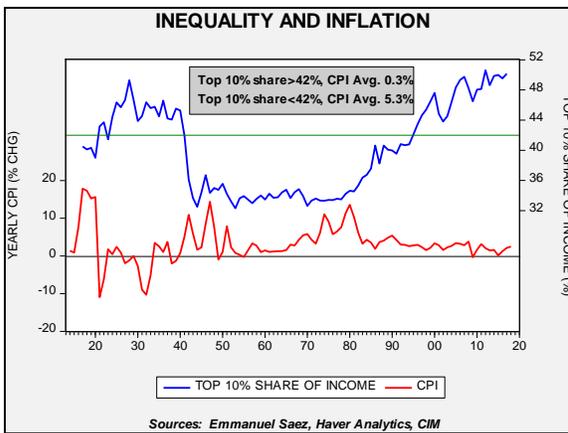
This chart shows the pattern of inflation from 1960 to 1983. Note the steady rise in

<sup>1</sup> Okun, Arthur. (1975). *Equality and Efficiency: The Big Tradeoff*. Washington, D.C.: The Brookings Institution.

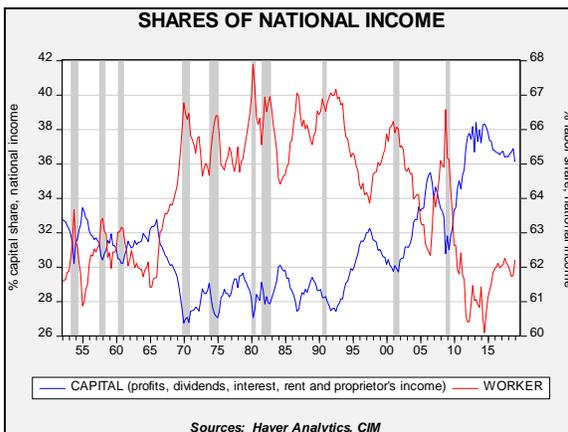
<sup>2</sup> Galbraith, John Kenneth. (1967). *The New Industrial State*. Boston, MA: Houghton Mifflin Harcourt.

each business cycle. Rising inflation was a serious problem for consumers.

To address this crisis, there was a switch in the Economic Triangle. Labor fell out of favor, while capital and consumers were advantaged. This shift to efficiency lowered inflation at the cost of higher inequality. The chart below shows the top 10% share of household income relative to inflation. It clearly shows that policies designed to lift efficiency and reduce inflation come at the cost of higher inequality.



Further evidence of this shift can be seen in the relative share of national income to capital and labor.



Since the fall of the Berlin Wall, capital has been taking a larger share of national income relative to labor in every business cycle.

Part of the efficiency policy has been globalization and deregulation. Another element has been anti-trust policy. Prior to the mid-1980s, market power alone would trigger anti-trust action on the idea that dominant companies were dangerous for markets. In the mid-1980s, legal theory shifted and the primary determinant of anti-trust action was harm to consumers. So, as long as they kept prices low, products safe and service levels high, large firms could avoid anti-trust scrutiny. This standard allowed large firms to garner political power and treat labor as they wished without repercussions.

If we are moving to an equality cycle, then a reversal of such policies is likely. The push against immigration and trade is clear evidence of deglobalization. The questioning of the U.S. superpower role is yet another example; globalization requires a stable superpower to provide trade security and a reserve currency. Without these global public goods, trade becomes regional at best. The steady drumbeat of the desire to regulate the tech industry is further evidence of the switch to equality. And, [the potential to change anti-trust regulation](#) would be another element of this shift to a new cycle.

Using the Economic Triangle, we would expect that capital will bear some of the cost. We would expect its share of national income to fall below 30% in the coming years. But, the consumer will also pay as the order adjusts between capital, labor and consumers. We currently live in an economy that is something of a consumer heaven. High levels of immigration have lowered labor costs. Households can have a plethora of items delivered to their door and often with “free” delivery. If labor costs rise, delivery costs will likely soar and end this practice.

### **Ramifications**

The Economic Triangle isn't perfect; no model can fully capture reality. For price discovery, the supply/demand paradigm still works well. At the same time, supply and demand has limitations when trying to understand the power structure because it presumes the interests of labor and capital are similar. That is simply not the case. Therefore, when examining power relationships in an economy, the Economic Triangle offers insights that supply/demand analysis cannot.

The most important market ramification from the issues discussed in this report is the growing evidence of a shift from efficiency to equality. This shift will eventually be inflationary as labor benefits, while capital and consumers see their relative power reduced.

Bill O'Grady  
July 29, 2019

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