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Stock-Market Valuation Is Not Wealth, and Neither Is Happiness

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Introduction

A recent popular meme makes a bold assertion. The picture shows a young child who appears to feel quite victorious and the caption reads, "Traded juice box for cupcake—Created wealth."[1] The meme's accompanying post attempts to substantiate the meme's assertion as follows: "Wealth is whatever people value, and according to the One Law of Business, we create it when we move resources from lower-value to higher-value uses"—and contains a link to an economics textbook by Froeb, McCann, Shor, and Ward.[2]

The title of the Froeb, McCann, Shor, and Ward chapter in which the authors first discuss wealth is "The One Lesson of Business." On the following page, the authors plainly state the aim of the chapter that follows: "The goal of this chapter is to teach you how to find and profitably exploit money making opportunities."[3] Without taking even a moment to *define* wealth, the authors go on to assert how wealth is created: "*Wealth is created when assets move from lower- to higher-valued uses*." Later, on the same page, the authors identify the mechanism: "*Voluntary transactions create wealth*."[4]

This essay will argue that both the meme and Froeb, McCann, Shor, and Ward play fast and loose with the definition of wealth in a way that obscures rather than clarifies what we mean by wealth. To clarify, let us plainly state what this essay will not do: It will not argue that wealth is the dollar-value of a person's assets. It will also not argue that wealth and subjective value are equivalent concepts, as suggested by both the meme and the aforementioned textbook.

Instead this essay will argue that *true wealth lies in the productive potential of the resources that one owns, or possesses within oneself, to satisfy the needs and wants of others*. In short, you are wealthy when you possess the creative capacity and insight necessary to increase the utility of others through mutually beneficial exchange. Your bank balance is not wealth, and neither is your happiness. Your wealth is found in your as-yet-unrealized transformation of what you currently possess into something valued highly by others according to their individual tastes and preferences.

Voluntary Exchanges Create Subjective Value Not Wealth

Ever since the "marginal revolution," economists have understood clearly that the value of a good or service does not lie alone in its production costs—an understanding that neither Karl Marx nor even Adam Smith had worked out.[5] The market value of a good or service is instead simultaneously determined by factors on the supply-side of a market, such as labor costs, together with the subjective valuations of potential purchasers of such goods or services on the demand side. Tuttle and others distinguish between the subjective value of a good or service to a given individual—"value in use"—and the market valuation of that same good or service—"exchange value" or "value in exchange."[6] On the demand side, potential Pareto improvements are found in instances where a given demander's subjective value lies above the exchange value of the good or service. Similarly, on the supply side, potential Pareto improvements are found when the exchange value of a given good or service lies above the marginal opportunity cost to the supplier of making that particular unit of the product available. In this way markets pair up high-value demanders with low-cost suppliers, and the exchange value will maximize the shared gains of the demanders and suppliers; we say that the outcome is efficient, and—once realized—there is no way to make one individual better off without harming another in order to do so. Thus voluntary exchange is mutually beneficial to both parties to a given transaction. Otherwise they would not agree to the deal.

Now consider two economies: One in which there is no production, and another in which there is. Such thought experiments are common in economics.[7] In the economy without production there is an initial exogenous allocation of resources—an allocation that might be equal or not. According to the first fundamental theorem of welfare economics, if the economic agents are permitted to participate in mutually beneficial exchanges until they exhaust all possible gains, then the resulting allocation is efficient in the Paretian sense. In such a

world, all the gains to all agents are subjective-valuation enhancements. We know this because each agent is a consumer of the resources and not a producer. So in each exchange we observe the same resources given in the initial allocation being reallocated in a way that enhances subjective value for each party to each transaction. If I value my apple more than my orange, I attempt to trade away my orange first in the hopes of finding someone who values my orange more than something he currently possesses and that I prefer to my own orange.

In such an economy, there are repeated gains in subjective value until all such gains are exhausted. As in any market economy, resources are relentlessly redirected from less-valued to more-valued uses. But our fundamental claim is that while a closed economy without production might have happier members after such trades, one would be hard-pressed—even using a layperson's understanding of wealth—to say that there is more wealth in the efficient outcome than in the initial distribution. It's the same stuff. The potential Pareto improvements from exchange have been realized, but society possesses exactly the same potential in the efficient allocation as in the initial one. The economic agents may be happier, but their ambition has ended. Nothing else is possible: No more trades, no more gains, no production, and only consumption.

Consider a simple example such as grade-school children entering their lunchroom with the lunches that each one brought with them to school that day. Though today it is largely forbidden for students to trade their lunch items,[8] it is easy to see that when one child trades a juice box for a cupcake no one would think of it as "wealth" being created. The initial allocation of resources is fixed, the economy is closed, and the children do not engage in productive acts. While the children who participate in the trades will be happier having traded, at the end of the day the food will be either eaten or discarded, and the students will burn off all the calories during recess on the playground. Tomorrow will require another exogenous resource endowment to the otherwise poor children in the room, and so will the day after that. In fact, the children would starve to death if trapped in the room due to a natural disaster. Their sustenance depends critically on repeated helicopter drops of new resource endowments since they possess none of their own.

Or consider a real-world, not-so-closed economy, perhaps a poor nation that currently possesses much of its own human or physical capital. Merely giving its citizens free stuff and letting them trade does not make them wealthier. In fact, it is possible that such gifts—even if given with the best intentions—might slow down the rate of economic advancement, as measured by productive capacity. The film documentary *Poverty, Inc.* makes this point well using the example of TOMS Shoes.[9]

In these scenarios, none of the additional resources received by the members of the economy leaves them with greater capacity. Every one of the economic agents is happier—that is, their own utility has increased as a consequence of exchanging something they value marginally little for something they value marginally more—but none of these initial resource endowments or the eventual Pareto-efficient allocations of those endowments provide the economy or its citizens with a greater capacity to produce. Without greater capacity to produce, one cannot say that the society is wealthier in one allocation—Pareto-efficient or not—compared to another. They are happier with their pie, but it is the same pie.

Wealth Includes—but Is More than—Financial, Human, and Physical Capital

Now consider an economy in which production by the economic agents is possible. In the simplest conception each economic agent is assumed to be both (1) a potential producer and (2) a consumer. In such an economy, even one with abundant natural or other resources, there is no guarantee that valuable production will take place, if it takes place at all.

Think for a moment about a commercial kitchen. Even if that kitchen were fully stocked with the finest cooking equipment, the wealth there does not lie entirely in the accumulated pots and pans and ovens and sinks. And even if you add to the endowment all of the ingredients necessary to prepare, from start to finish, a magnificent dessert, the wealth does not lie entirely in the sum of the market value of the flour, sugar, eggs, and culinary tools.

The true wealth lies in the productive potential of those things to create further value.

But their potential remains unrealized without the cook who has perfected the recipe and baked it hundreds of times so it comes out flawlessly. Yet even with a master chef, the wealth in that kitchen cannot be fully realized. It requires an entrepreneur to discover what needs making in the first place, by addressing himself first to what others might value highly. The entrepreneur must speculate about what might be made, and maybe it is not a cake at all. In fact, maybe the kitchen needs to be liquidated so that the entrepreneur can transform it into something people prize more highly. And, of course, the entrepreneur must then figure out a way to create something valuable for others that he can sell at a price that allows him to cover his opportunity costs incurred in the effort. If he cannot do that, he fails and tries again.

Schumpeter makes it quite clear that wealth comes from productive capacity—not from accumulated stuff.[10] According to Schumpeter, even economies with production might enter a stationary state if there is no innovation by entrepreneurs. In the absence of entrepreneurial innovation, economies are sustainable but they never advance, because they produce just enough output to sustain their lives and productive capacity from one period to the next. This state would be like a group of schoolchildren who, already possessing the capacity to prepare their own lunches from day to day, accomplishes no more in the current school day than in all the other prior days that year. The lunches pretty much taste the same, and there is no additional capacity to produce either more delicious lunches or more nutritious ones. Thus the subjective value realized each period is precisely the same as in the prior day. No one is getting any wealthier in any meaningful sense. Trading a juice box for a cupcake is not creating wealth.

For a society to break out of its current state, disruptive innovations are required. Schumpeter defines such innovative development as "spontaneous and discontinuous change in the channels of flow, disturbance of equilibrium which forever alters and displaces the equilibrium state previously existing."[11] For Schumpeter, innovations might include the introduction of new products, improving the methods of producing existing products, the discovery of new markets, or the acquisition of new productive resources. Ballor and Claar discuss such innovations in their review of the historicity of entrepreneurship, invention, and innovation.[12]

Of course, such disruptions cannot happen on their own. The entrepreneur is the key disruptor for Schumpeter. Regardless of the motives of entrepreneurs, they are the drivers of increasing productive capacity to satisfy currently unmet needs and wants. Indeed, entrepreneurs are the first-movers in the creation of wealth in the sense we mean here.

Wealth Creation Is Not All Fun and Games

Though Schumpeter is perhaps best known for his articulation of the process of "creative destruction" in Capitalism, Socialism, and Democracy (1942), one finds that concept already present in The Theory of Economic Development (1934). The most famous passage in the later work reads,

> The opening up of new markets, foreign or domestic, and the organizational development from the craft shop to such concerns as U.S. Steel illustrate the same process of industrial mutation—if I may use that biological term—that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism.[13]

Yet one sees this process already present in the earlier work. In fact, Schumpeter models the business cycle itself as driven by repeated "boom" and "bust" periods—owing to those pesky yet wonderful entrepreneurs. As Ballor and Claar note, Schumpeter's entrepreneur is grand—increasing his own status in commercial society by disrupting current circumstances in ways that disrupt the existing power structures as well as current modes and means of production. And along the way the Schumpeterian entrepreneur takes great delight in making things new though his innovation creativity.

Though Kirzner's entrepreneur may be grand—like Henry Ford—or modest—like the wonderful accident of 3M's Post-It Note—the same holds true: In the absence of entrepreneurship we would be condemned to a static state in which wealth never advanced. Again, wealth is best understood as the creative capacity of an individual or an economy to produce goods and services that are valued by others in that marketplace. While it is true that Henry Ford became rich, he was able to do so by supplying something to consumers that lay far beyond the productive capacity of the pre-existing accumulated productive materials found in machines, money, labor, and natural resources.

With Freedom to Produce, You Will Never Be Poor

What are the implications of the preceding for the individual who currently feels poor because he lacks material possessions? The good news is that if you simply possess the freedom to engage in productive, creative acts, then you are never poor and you further enjoy the prospect of increasing wealth over time. Indeed, the ultimate source of creativity and innovation lies within each of us, and in the Christian tradition we each bear within us the Imago Dei—God's own creativity reflected in each one of us. That is, each of us is already born with some wealth, in the sense described here, because we all possess creative capacity and the ability to work. But we may only realize the value of our wealth when societal institutions help us recognize that pre-existing wealth and also give us the freedom to discover how to most effectively direct that wealth in the service of others. In the presence of healthy moral and cultural institutions—ones that allow discovery to burst forth rather than be stifled or stopped altogether—each of us, individually and together, can realize the importance of wealth clearly defined and understood.

Notes

1. "Economics in One Meme" (internet image), 2019, https://www.facebook.com/EconomicsInOneMeme/photos/a.543441472447640/1657940094331100. It is a variant of the Success Kid/I Hate Sandcastles meme. See "Success Kid/I Hate Sandcastles," Know Your Meme, https://knowyourmeme.com/memes/success-kid-i-hate-sandcastles.
2. Luke M. Froeb et al., *Managerial Economics*, 4th ed. (Boston: Cengage, 2016).
3. Froeb et al., *Managerial Economics*, 15–16.
4. Froeb et al., *Managerial Economics*, 16, italics in original.
5. Israel M. Kirzner, "Another Look at the Subjectivism of Costs," Working Paper, Foundation for Economic Education, n.d., https://history.fee.org/media/2632/1290-another-look-at-the-subjectivism-of-costs.pdf.
6. Charles A. Tuttle, "The Wealth Concept: A Study in Economic Theory," *Annals of the American Academy of Political and Social Science* 1 (April 1891): 628.
7. See, for example, Hal R. Varian, "Equity, Envy, and Efficiency," *Journal of Economic Theory* 9 (1974): 63–91.
8. See, for example, Suzanne Domel Baxter, William O. Thompson, and Harry C. Davis, "Trading of Food During School Lunch by First- and Fourth-Grade Children," *Nutrition Research* 21 (2001): 499–503.
9. *Poverty, Inc.*, film (2014), ColdWater Media, directed by Michael Matheson Miller.
10. Joseph A. Schumpeter, *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*, trans. Redvers Opie (1934, repr., New Brunswick, NJ: Transaction, 2012).
11. Schumpeter, *Theory of Economic Development*, 64.
12. Jordan J. Ballor and Victor V. Claar, "Creativity, Innovation, and the Historicity of Entrepreneurship," *Journal of Entrepreneurship and Public Policy* 8 (2019): 513–22.
13. Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 3rd ed. (1st ed. 1942; New York: Harper and Brothers, 1950), 83.