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Consumption, Innovation, and the Source of Wealth

Let producers produce.

ECONOMICS INNOVATION



Steven Horwitz

My penultimate column of 2010 set off minor fireworks in the blogosphere, with negative responses ranging from Matt Yglesias's civil but critical reply to Brad DeLong's typical incivility (though I am proud to have, for a second time, made his "stupid people" list). It also was praised and reprinted in a number of places, and in several languages, across the free-market blogosphere. I'll happily take that tradeoff.

In that column I argued that the key to a healthy economy is production not consumption, and that the attention paid to increasing consumption during downturns is misguided. I was accused of holding a naïve version of Say's Law because I appeared to claim that "supply creates its own demand." However, I have written several pieces (examples [here](#) and [here \[pdf\]](#)) arguing that this is a misreading of Say's Law. His actual text shows the law is better rendered as "production is the source of demand": We cannot exercise consumption demands without having first produced value (or getting resources from those who have).

This argument hardly aligns me with the "interests of rich people and powerful business executives," as Yglesias claims. It applies to *all producers of wealth, from minimum-wage workers to midlevel managers to the rich and powerful*. In a depoliticized, freed market,



consumer.

The ultimate source of wealth in society is producers who create value. The hourly worker creates value by providing a marginal product whose value is greater than the real wage she is paid (though competition tends to compete this differential to a minimum). The firm as a whole creates value by producing an output that consumers value more than the sum of cost of the inputs used by the producer, including the value of the time the production process takes.

Constant Innovation

All this value creation can be seen as forms of innovation. As Deirdre McCloskey argues in her new book, *Bourgeois Dignity*, capitalism is best understood as a system of constant innovation. Firms that figure out a better way to get consumers what they want, either by producing it with less-valuable inputs and/or changing making the final product more valuable to consumers, are innovators who create value and wealth. Ongoing acts of successful innovation (as judged by genuine market profit) create wealth for both the innovator and the consumer.

The wealth for the innovator is the profit she earns. The wealth created for the consumer comes as either lower prices through lower-cost production or improved and hence more-valuable goods. In addition, workers who produce more-valuable goods and services see increases in their wages and hence their wealth. The value-creation that comes from the ongoing innovation of the market is what creates the wealth that makes consumption possible.

Notice that even though the producer clearly is thinking about the consumer when she innovates, wealth-creation does not require an already-existing increased power to consume. An act of innovation alone produces wealth by cutting costs or adding value to a product. Thus to suggest that my argument is undermined by the fact that the goal of production is consumer satisfaction is to miss the point. Yes, producers produce because there are consumers who consume, but it is *production not consumption that creates wealth*.

Why Is Labor Idle?

This is no less true in a recession or during high unemployment. The problem is not getting consumption power directly in the hands of idle labor. The problem is whatever is



There are several possible answers to this question, and just about all of them, in my view, are related to the misguided government policies of the last several years that have created an environment in which the private sector is pessimistic about the prospect of creating wealth. Getting people back to work and returning the economy to wealth-creation will happen because production revives and not because we “stimulated” consumption.

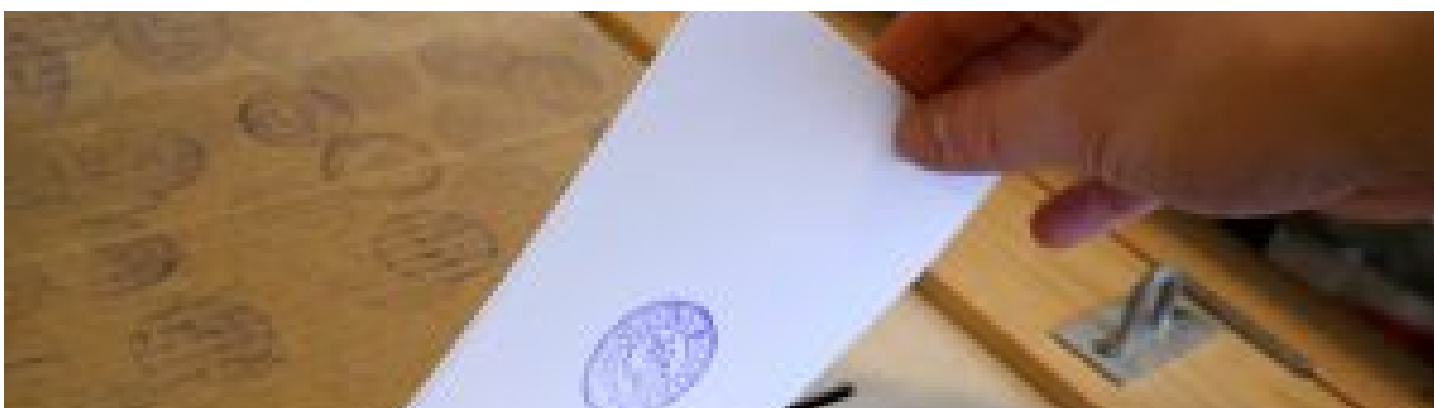
Innovation by producers, not consumption, is what creates wealth in a market economy. Producers know that simple truth, and I think most citizens know it deep down as well. But sometimes the simplest truths are the hardest for the self-proclaimed elite to understand.

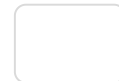


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