A VALUE CREATION THEORY OF THE ECONOMY – A NEW TOOL FOR BUSINESSES, THE PUBLIC, AND POLICYMAKERS TO UNDERSTAND THE ECONOMY

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SUMMARY: This economic study, using the grounded theory research design and an extensive review of, and incorporation of, other economic and financial models and theories, explores how free-market-based, capitalistic economies operate through business enterprises to create economic prosperity. The creation of enterprise value by businesses creates value in the economy, which leads to economic prosperity. This paper is for policymakers, business owners, the general public, and others to help them better understand the functioning of the economy, particularly as it pertains to the private enterprise's role in creating economic value and economic prosperity.

Introduction

This is a profit-making organization - that's the way it was intended, and that's the way it is ~
A sign in a stock brokerage office, circa 1972

The sign in the stock brokerage office (circa 1972) typified the prevailing attitude of the time - that business was good; that businesses were supposed to make a profit; that the entrepreneurs that took risks to start and run business enterprises were supposed to benefit from their risk-taking activities; and that the actions of these entrepreneurs and the businesses they created led to economic prosperity for everyone. These favorable attitudes toward entrepreneurs and businesses have shifted over time. Today, many prevailing attitudes toward businesses and entrepreneurs have become considerably less favorable. Mackey and Sisodia (2014) note that: "Despite enabling widespread prosperity, free-enterprise capitalism has earned little respect from intellectuals and almost no affection from the masses" (p.15). Porter and Kramer (2011) observe that: "The capitalist system is under siege. In recent years business has increasingly been viewed as a major cause of social, environmental, and economic problems" (p. 64).

The purpose of this economic study, using the grounded theory research design and review of, and incorporation of, other economic and financial models and theories, is to explore how free-market-based, capitalistic economies operate through business enterprises to create economic prosperity. The method of the paper is to pose a series of propositions based on the conceptual framework of Cropanzano (2009, p. 1305), where he notes that a theory article "…proposes a specific conceptual model and builds a case in support of this framework. The authors typically pose a series of propositions that are derived from the model."

This paper provides a comprehensive view and shows a clear path of how value creation starts with the entrepreneur; then moves to the firm through value drivers and management tools; then transitions to the broader economy to create economic prosperity. Value creation takes place throughout the process, not just at the end. For example, as businesses spend on labor, an economic factor of production, that spending takes place in the broader economy throughout the process of economic activity (as shown in Figure 3). A new term, "Intrinsinomics," was coined for the value creation theory of the economy. This portmanteau word is a combination of the words intrinsic value and economics and was created to distinguish the value creation theory of the economy from other value creation theories.

There are no new steps to value creation that are being established in this paper. The uniqueness of this theory is in connecting and highlighting the steps that have long been present in the creation of economic value and prosperity and explicitly discussing what has yet to be extensively explored or discussed in previous studies of which the author is aware. The value creation theory of the economy is built upon value driver theory (formally known as a theory of value drivers). It is the next stage in the evolution from the theory of investment value (Williams, 1938) to the theory of value drivers (Wendee, 2011) to the value creation theory of the economy, the subject of this paper (Wendee, 2021a, 2021b), as shown in Figure 1. This is the first study of which the author is aware, to connect, in a detailed way, financial models of value creation, particularly the discounted cash flow model (DCF), which is often used to study the creation of value in individual enterprises, to the creation of value in the overall economy. This study, and the associated theory of value drivers (Wendee, 2011), examine the anatomy of value creation from both a financial and economic standpoint.

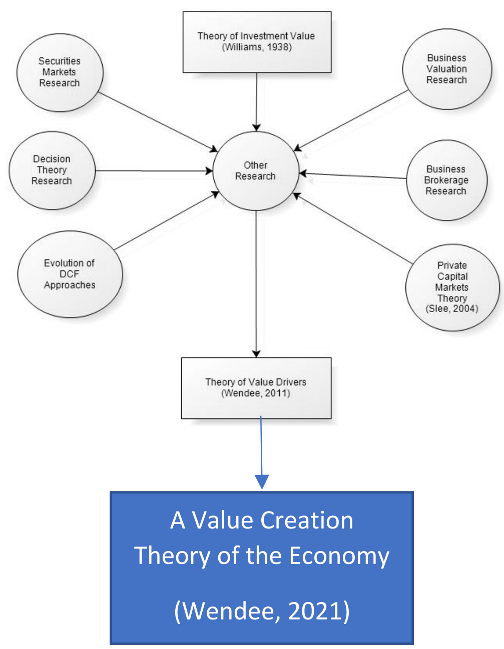

Figure 1. *Evolution from the theory of investment value to the theory of value drivers to a value creation theory of the economy.* Adapted from Wendee, 2011.

Literature Review

The development of the value creation theory of the economy, which commenced in the Spring of 2019, was a process of discovery and was accomplished by utilizing the grounded theory research design and an extensive review of, and incorporation of, other economic and financial models and theories. Several hundred references, including over three hundred references specifically used in the development of value driver theory, were reviewed for the current study over the past four years as a part of an ongoing study of value creation in individual enterprises and in the overall economy.

The coded results of the literature review and the extensive review of, and incorporation of, other economic and financial models and theories comprised the data used to generate the theory. Glaser (1998) notes that sometimes it is necessary or desirable to use the literature earlier in the grounded theory research study than is normally desirable, as was done in this study. It became apparent in conducting the literature review for the current study that a theory was emerging from the data in the literature itself. Once this became apparent, the paper shifted from simply listing various literature sources to incorporating the literature into the study as part of the various elements of conducing grounded theory research.

As the study used the grounded theory approach to generate a theory, reviewing the general perspective on the characteristics and formulation of theories is important. In this regard, the observations immediately following and found later in this paper regarding theory formulation may be helpful. Theories are products of the minds of theorists (Dubin, 1978). Kaplan (1998) notes that "A theory is a symbolic construction…that [theories] do not share the ineluctability of fact" (p. 296). Whetten (1989) suggested that theorists should recognize that "over time their ideas will be refined" (p. 490). Whetten further noted, "By definition, all the relationships in the [theoretical] model have not been tested. If all links have been empirically verified, the model is ready for the classroom and is of little value in the laboratory" (p. 491).

Several key areas of value creation theory (Windsor, 2017) were reviewed in the literature review for this paper. In value creation theory, there are two main schools of thought for how value is, and should be, created for each individual enterprise in the economy and for society at large (Windsor, 2017). The two schools of thought are: (1) conventional agency theory; and (2) managerial stakeholder theory. In the conventional agency theory model, the creation of firm value is the core purpose of economic exchange (Vargo, Maglio, & Akaka, 2008, p. 145). In the managerial stakeholder theory model, generating value for multiple stakeholders is the goal (Crane, Graham, & Himick, 2015).

There are variations and proposed enhancements to the conventional agency theory and managerial stakeholder theory models. The concept of creating shared value (CSV) (Porter & Kramer, 2011) suggests that societal needs define markets as much as conventional economic needs; that social harms and weaknesses create internal costs for firms; and that addressing societal needs doesn't have to be about a redistribution of value, but instead "it is about expanding the total pool of economic and social value" (Porter & Kramer, 2011, p. 65). Mackey & Sisodia (2014) advocate for a similar approach with their concept of Conscious Capitalism. Triple Bottom Line (TBL) (Elkington, 1998) suggests that companies focus on people, planet, and profit. Creative capitalism (Kiviat & Gates, 2008) advances the notion that companies should expand their market reach to people at the lower end of the economic spectrum and that companies that do this can benefit from public recognition and enhanced reputation.

One important consideration is what is meant by "value"? Windsor (2017) asks whether value is objective (i.e., market determined) or subjective (i.e., socially constructed). Windsor (2017) notes that, in general, value creation means an increase in net benefits to some or all of the recipients of value. In economic terms, it is a combination of consumer surplus and producer surplus (Mankiw, 2021a, 2021b; Windsor, 2017). In the context of this paper, value is understood to be the "intrinsic value" that is calculated using the discounted cash flow methodology (discussed later in this paper). Warren Buffett (Buffett, 1996) describes intrinsic value as follows: "Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life." An extension of the intrinsic value concept (Behera, 2020) is Economic Value Added (EVA) (Stern, Stewart, & Chew, 1996), which explores the value that is added to the opportunity cost of capital invested.

Propositions Development

Value Creation Theory of the Economy

There are two main parts to the value creation theory of the economy. The first part, which describes how firms create value for their shareholders, is described by the theory of value drivers study (Wendee, 2011). The Value Creation Process Chart (Figure 2) is a tool used to illustrate value driver theory. The theory of value drivers study can be accessed through ProQuest.

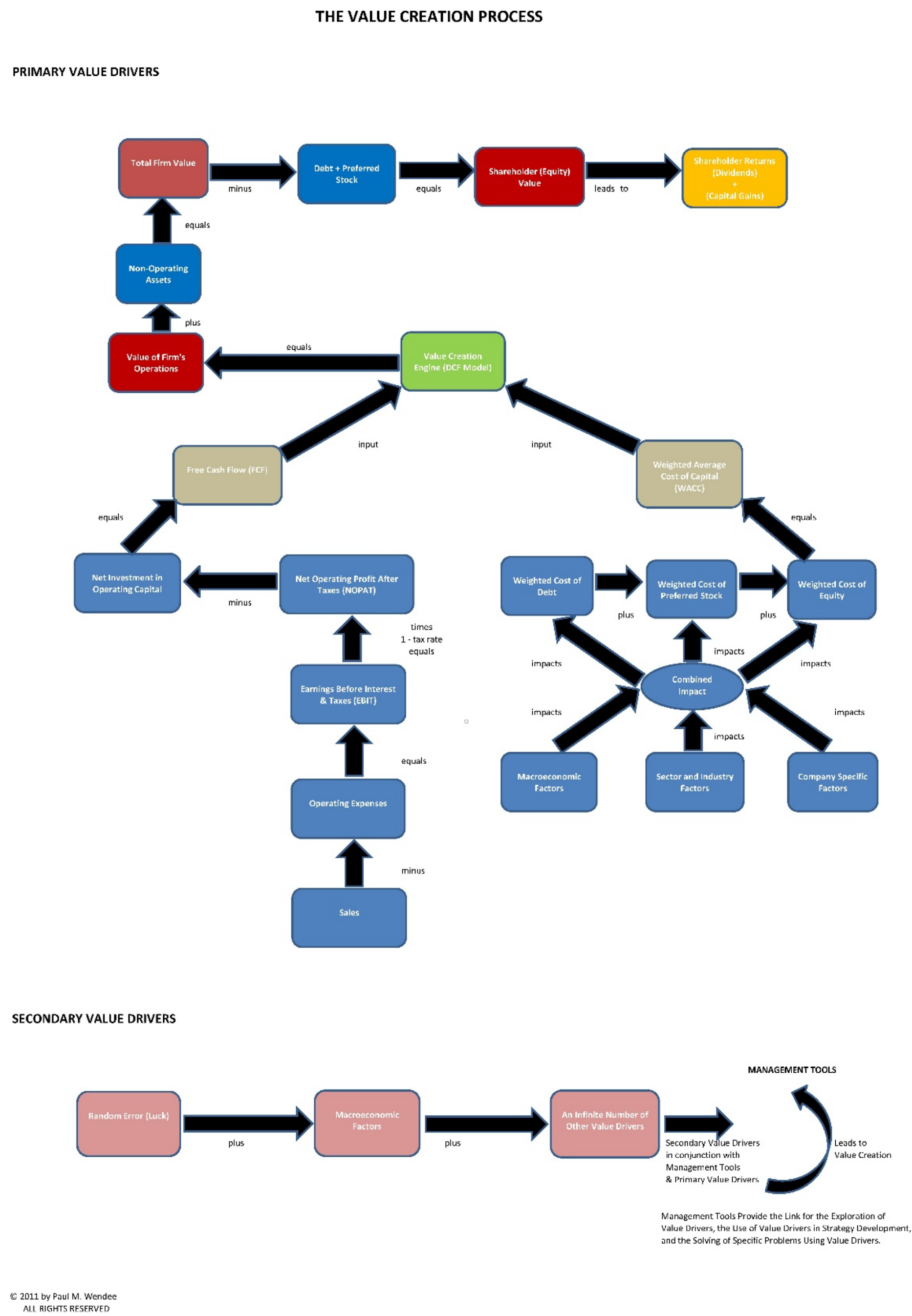

Figure 2. *The value creation process chart.* Adapted from Wendee, 2011.

The value creation theory of the economy itself is the second part and is the subject of this paper. The Intrinsinomics Model of the Circular Flow of the Economy (Figure 3) graphically shows the link between the value created by the firm for its shareholders and the value that is created in the overall economy.

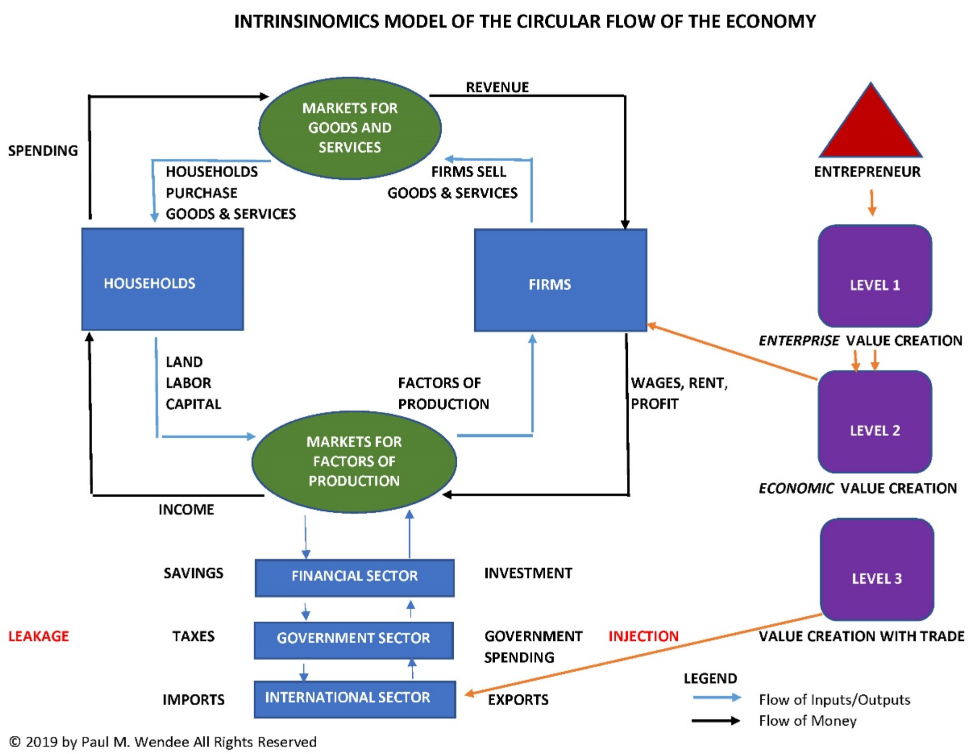

Figure 3. *Intrinsinomics model of the circular flow of the economy.*

Propositions of The Value Creation Theory of the Economy

This section includes a discussion of the elements of the value creation theory of the economy. The elements are presented and discussed as a series of propositions. Figures 2 and 3 graphically depict the relationships and properties of the value creation theory of the economy.

Proposition – Free markets are usually the best at organizing economic activities. In the long-run, free markets are usually the best way to organize economic activity. For a discussion of this point, see (Mankiw 2021a, Mankiw 2021b). Scarcity is an economic principle that affects all economies. In this regard, free markets are the most efficient and effective way to allocate scarce resources.

Proposition – Circular flow model of the economy efficiently analyzes how an economy works. The circular flow model of the economy, as illustrated in Figure 3, is a useful, general model for analyzing how an economy works. Upon examination of the circular flow model in Figure 3, it becomes apparent that firms, along with households, are at the center of value creation in an economy.

There are four generally recognized factors of production in an economy: (1) land; (2) labor; (3) capital; and (4) entrepreneurship. The entrepreneur is a main driver of the engine of economic growth. According to the St. Louis Federal Reserve (Factors of Production, 2019): "An entrepreneur is a person who combines the other factors of production - land, labor, and capital - to earn a profit." As a factor of production, labor is a necessary and vital component of economic growth. But it is not a driver of economic growth.

Proposition – Firms create value for their shareholders through the discounted cash flow (DCF) model. Using value drivers (Wendee, 2011), firms create value for their shareholders. According to Wendee (2011): "Value drivers exert their influence on the value of an enterprise by operating, directly or indirectly, through the discounted cash flow model (DCF model)."

Proposition – Value in the economy is a function of firm value. The value that is created in the economy is a function of the value that is created by every firm in the economy. The value that is created by firms in the economy is an exponential function. It is not simply additive. This is due to the benefits of comparative advantage, the multiplier effect, and other synergies that take place in an economy (Mankiw, 2018a, p. 453).

Proposition – Standard of living depends on a country's ability to produce. Production is vitally important to an economy's ability to foster economic prosperity. According to Mankiw (2018a): "A country's standard of living depends on its ability to produce goods and services" (p.13).

Proposition – The economic value creation occurs at three levels. As shown in Figure 3, the value creation that takes place in this theory occurs at three levels:

Level 1 – Firms create value for themselves.

Level 2 – All of the firms in an economy create value for the economy as they create value for themselves.

Level 3 – The economy creates value by acting as a business itself in the global economy.

The entrepreneur starts the entire value creation process beginning at the firm level. Entrepreneurs can also be thought of as managers in the factors of production models.

In an open, global economy, where economies have free interaction with each other, each economy in effect acts as a business in its trading of goods and services with other economies. This is shown in Figure 3.

Proposition – The role of government. The value creation theory of the economy suggests that government should have a limited role in the economy and society at large. Some economists believe that the only proper role of government is to: (1) protect property rights; (2) adjudicate disputes; and (3) provide a legal framework in which voluntary trade is protected. See for example Government's Role in the Economy (2008).

In general, deadweight losses are created by government, taxes, labor unions, and other market disrupters as a result of market distortions.

There is also the crowding-out effect, whereby an increase in government purchases causes the interest rate to rise, reducing private investment spending, and putting downward pressure on aggregate demand (Mankiw, 2021a, p. 453).

Firms, along with entrepreneurs/managers, are the main driver of economic activity. Hampering the ability of firms to create value for their shareholder curtails economic growth.

Proposition – Benefits of firm value creation revert to the economy. As firms create value for their shareholders, many of the benefits that result from the process of that value creation revert to the economy in the form of wages (labor), rents (landowners), and profits (shareholders). It should also be recognized that a large part of the population in the United States owns the firms that are in the economy, either outright through stock ownership, or indirectly through ownership of retirement plans and other employee benefit plans that hold the stock of public and private businesses.

Conclusion

The paper proposes a value creation theory of the economy, built upon a previous study known as the theory of value drivers. Both this study and the previous theory on value drivers, are part of an evolution from the theory of investment value (Williams, 1938) to the value creation theory of the economy, as shown in Figure 1. This paper is for study and use by policymakers, business owners, and the general public. It is designed to be a practical theory, helping in the understanding of how the economy works and providing a further basis for research. As Van de Ven (1989, p.486) observes: "Good theory is practical precisely because it advances knowledge in a scientific discipline, guides research toward crucial questions, and enlightens the profession of management."

This study proposes a theory that places businesses and private enterprises at the center of economic value creation and economic prosperity. The process by which this happens is that firms strive to create value for their shareholders, creating the economic activity that creates value in the economy, which in turn leads to economic prosperity.

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