

# Theory and Reality

Anne Emerson, April 2023

*“If Reality and Theory Don’t Match, it’s Reality that’s Wrong.”*

The above quotation was a dinner-table joke, made many years ago. In today’s world, it may be a different kind of joke. The purpose of this essay is to share a few aspects of economic theory that may surprise you.

The leading article in a recent edition of *The Economist* (January 14-20, 2023) says that we should not fall prey to “zero-sum” thinking, which is “the destructive logic that threatens globalization.” Yet, this essay explains how we can investigate international inequities in terms of zero-sum logic. Economic analysis usually involves an economic model, of which there are two main types. Both types of models may downplay financial inequities, as explained below.



*Microeconomic models* address issues such as how incomes are distributed among workers and business-owners, within the larger picture. *Macroeconomic models* explore “big picture” economics, usually dealing with a national economy, referencing aggregates such as “inflation,” “unemployment,” or “economic growth.”



## Three Astonishing Facts About Economic Modeling

*Astonishing fact number one:* Most microeconomic models steer well clear of money. Economists believe that economics is about “real stuff.” That is to say, the economy is that which allocates “stuff,” such as fruits, vegetables, cars, houses, parks, and healthcare, among people.

Microeconomic models and international trade models are built around an idea we might call “terms of trade,” or how many fruits will trade for how many vegetables; or computers for cars, or houses for parks. Money is known to facilitate the exchange, in case computer-sellers don’t want exactly that many cars, or house-sellers don’t want parks at all, but money does not usually appear directly in these models.

So, one pink peony is of equivalent value to (say) one red peony, or one cabbage may be priced at “two apples.” The impact of who owns what money is not in this type of model.



Suppose, for example, that someone uses his or her money to persuade people to move goods and services around, or to dictate what kinds of things other people will make. Suppose, further, that money-owning behavior changes what is available in the world, and how an economy serves its people. In such a case, how many

economists would you want to see ignoring the “directing and controlling” aspect of owning money, in their models of how things work?

*Astonishing fact number two:* Most macroeconomic (i.e., whole-country) models do acknowledge money as agent; yet they imply that money as agent works the same for everyone. Easy access to credit is good for business investment and therefore, for economic growth. And, that serves the economy and all its residents well.



However, articles in prior editions of *The Economist* suggest that some such policies may not benefit everyone. In the Euro zone several countries use the same currency – the Euro – yet monetary policies benefiting richer countries make financial challenges worse for poorer countries.

What if financial challenges of poorer regions or individuals, within one nation-state, fall below the nation’s monetary-policy radar? (Financial inequities may be harder to link to policy, within-country, than across countries as in the Euro zone discussed above.) Then, it may be possible for a government to promote social equity via some policies, while at the same time pursuing a growth-oriented monetary policy which may undermine those social-equity policies.

*Astonishing fact number three:* Most economists did not include technological change in their models prior to 1992. It was believed that the main source of economic growth was “capital.” “Financial capital” is money for investment; “physical capital” is plant and equipment; “human capital” is education and skills. Each of these types of capital can contribute to building more and better material things.



Since each new iteration of “capital” is technologically more sophisticated and can accomplish more than the previous one – economists added a variable for technological change into their capital-focused models (late in the game – 1992).

This new variable sits, mostly, in the equations for production. Modeling how technological knowhow leaps across sectors and industries is challenging when each individual production process contains its own, isolated, “technology” variables. Moreover, the role of consumers’ demand in directing technological change – via financial incentives that may realize certain technologies rather than others – is not easily explored in this type of set-up.



Suppose consumers believe that “cheap and efficient” is good value, but good service should be free? They will not pay a premium for good service, and good service may disappear. Or suppose that U.S. consumers believe everyone can have more and better things, if the rest of the world would learn to be like us? Would we still appreciate more and better things, if another country started to outsmart us at making more and better things?

If you started to see the flip side of cheap, efficient, more, and better, would you continue to buy more and better, cheaper things? Or might you start to explore social-emotional-community technologies (“technology” originally meant “knowhow”)? If so, would you want to see economists discuss the unintended consequences of cheap, efficient, more, and better? Would you want to see a discussion of why some people approach trade as though it might be a zero-sum game?

### **Summary and Conclusion:**

The discussion so far has shown that terms-of-trade models ignore the agency, or directive, role of money. Macro-models can suggest that a whole nation-state responds as



one to monetary policy. If these two simplifications ignore real-world inequities in financial agency, or ability to direct the system, then we can indeed talk about international trade in terms of “zero-sum” logic.

*Zero-Sum Games:* Games, in general, have human-made rules that regulate how they are played. The simplest example of a zero-sum game is chess. One winner, one loser, or a draw. There is no opportunity for win-win. Another example of a zero-sum game is where we split \$1,000 among ten people. We can do this in various ways (with various rules, such as drawing straws), but we cannot turn that \$1,000 into more than \$1,000. A “zero-sum” game (or set of rules) in economic theory is one where we can’t make more of whatever the prize is. “If I own it/win it, you don’t.”



When it comes to money, if you own it/win it, I don’t. That is, *ownership of money* is a zero-sum game. Even though making and sharing “stuff” may not be a zero-sum game, ownership of money and its agency is. Trade (both international and internal) is accomplished with exchange of money as well as “stuff.” So, we might wish to think about inequities in trade that arise from inequities in ownership of money.

*The Economist’s* leader (cited above) seems to say, “Zero-sum thinking is wrong, because in theory we can figure out a way for everyone to be better off.” If, as many of us believe, money is the most powerful means of getting things done, then those who own and direct more money will get more done, according to what they want, than those with less money.

This zero-sum aspect of money-ownership suggests an international battle for financial domination (that is, the power to direct others), in pursuit of the national interest, or of the personal interest, rather than in pursuit of an international win-win, as terms-of-trade theories might imply.



**Postscript:**

As people start to doubt the value of economic growth (that is, the ongoing production of more and better things), some buy environmentally-conscious products; or buy from local businesses when they can; or donate to charities whose work they respect. Some businesses and charities are responding accordingly.



order to spend time, effort, and money on rebuilding a social and moral fabric.

Yet, these behaviors do not address a perceived disintegration of the social and moral fabric. What if a more, better, cheaper “stuff” mindset becomes a STEM-promoting runaway train, increasingly opposed to humans’ non-material needs? To turn it around, we may also need proactively to resist the enticements of the easy life, in