IN ESSENCE

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ECONOMICS, LABOR & BUSINESS

Maximizing the Multiplier

THE SOURCE: "Crisis Economics" by N. Gregory Mankiw, in ***National Affairs***, Summer 2010.

When Team Obama arrived at the White House in January 2009, the first order of business was tending to a very sick patient: the U.S. economy. The administration's doctors (a.k.a. economic advisers) made a diagnosis (flagging aggregate demand) and prescribed a course of action (government spending).

Their plan was based on the Keynesian paradigm that for every dollar the government spends, the recipient of that dollar will turn around and spend some portion of it too (saving the rest), as will the next person, and the next person, and so on. This is called the multiplier effect. The Obama team estimated that government spending would have a bigger multiplier (1.57) than tax cuts (0.99), the other possible strategy for ramping up aggregate demand. When federal stimulus spending failed to bring the economy back to life, the administration economists concluded not that their basic prescription was flawed but that the patient had been much, much sicker than they had realized. The stimulus hadn't been big enough.

Perhaps, says Harvard economist N. Gregory Mankiw, but "to react to a model's failure to predict events accurately by insisting that the model was nonetheless right—as Obama's economic advisers have done—is hardly the most obvious course."

Economists should "constantly test [their] assumptions and policies against real-world results," says Mankiw, who chaired President George W. Bush's Council of Economic Advisers (CEA) from 2003 to 2005. And though predicting the effects of economic policy is quite difficult—there are an outlandish number of variables, all influencing one another—a recent spate of research has shown that the multiplier effect of tax cuts may be more sizable than previously thought. (Ironically, Mankiw notes, Christina Romer, former chair of the CEA under President Barack Obama, once coauthored a study that found that the tax cut multiplier was three times larger than what the Obama administration estimated it to

be.) Of course, as with any economic policy, the details matter greatly, and a poorly designed tax cut could be just as ineffective as poorly spent government funds.

Even if economists could perfectly predict the future, their prescriptions would still be subject to the vagaries of the political process. Politicians, after all, must answer to voters, not data. Still, Mankiw advises, "The foremost job of economists is not to make the lives of politicians easier, but to think through problems . . . and to propose the solutions most likely to work."

ECONOMICS, LABOR & BUSINESS

Theory-Free Foreign Aid

THE SOURCES: "The Pragmatic Rebels" by Maureen Tkacik, in ***Bloomberg Businessweek***, July 2, 2010, and "The Credibility Revolution in Empirical Economics: How Better Research Design Is Taking the Con Out of Econometrics" by Joshua D. Angrist and Jörn-Steffen Pischke, in ***The Journal of Economic Perspectives***, Spring 2010.

Two warring camps have divided the field of development economics in recent years. One side, led by Columbia University professor Jeffrey Sachs, argues that massive infusions of foreign aid can bring the developing world out of poverty. On the other side, led by William Easterly of New York University and economist Dambisa Moyo, are those who criticize foreign aid, saying it has not helped poor countries create jobs or industry but fostered dependence on Western handouts.

Now a group of young economists based at the Abdul Latif Jameel Poverty Action Lab (J-PAL), at the Massachusetts Institute of Technology (MIT), are staking out a third position: Enough with your grandiose theories, they say. Let's look at very small, specific actions (subsidies for mosquito nets, for example, or incentives for vaccines), and test which strategies work best for the least cost. Established in 2003 by Esther Duflo, Abhijit Banerjee, and Sendhil Mullainathan, J-PAL has quickly grown to include 46 professors at about a dozen universities conducting at least 200 randomized control trials in 33 countries.

> Could it be time to look at foreign aid and just test which strategy works best?

Duflo won a 2009 MacArthur Foundation "genius" grant for her work, which "is so minutely focused that its importance is not easily grasped at first glance," observes journalist Maureen Tkacik. In one representative study, Duflo found that Kenyan farmers were just as likely to buy fertilizer if free shipping were offered as they were if offered the fertilizer at a heavily subsidized price. Since the shipping discount was cheaper, the discovery should allow aid givers to get more bang for their buck.

Empirical economists have been criticized for focusing on situations that are too "narrow" or trivial to have any useful implications for policy, note economists Joshua D. Angrist of MIT and Jörn-Steffen Pischke of the London School of Economics in *The Journal of Economic Perspectives*. But over time, the cumulative results of many small empirical studies may supply the building-blocks for bigger theories, as has happened in the field of medicine, in which "clinical evidence of therapeutic effectiveness has for centuries run ahead of the theoretical understanding of disease," Angrist and Pischke explain. In their study of the increased use of empirical tools, not just in development economics but in labor economics and public finance as well, they assert their hopes that the fields of macroeconomics and industrial organization will find uses for these methodologies too.

For their part, the "randomistas" (as Duflo and her associates are sometimes derisively called) are not discouraged by critics, Tkacik reports. Many of them grew up watching big-name economists issue sweeping but "ultimately ineffectual" policy prescriptions. As Duflo puts it, "Ideology doesn't really matter so much when the objective is getting kids to show up for school or immunizing children."

ECONOMICS, LABOR & BUSINESS

How Nations Get Ahead

THE SOURCE: "Was the Wealth of Nations Determined in 1000 BC?" by Diego Comin, William Easterly, and Erick Gong, in ***American Economic Journal: Macroeconomics***, July 2010.

Why are some areas of the world so poor and others so wealthy? Economists generally look for answers in contemporary conditions, such as the soundness of economic policies or the presence of political instability. When they do look to history, they tend to point to the Industrial Revolution or the colonial period