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ECONOMIC VIEWPOINT

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The Increasing Importance of Behavioral Economics for Policy

One of the clear messages coming out of the Great Recession is that economists and policy wonks need to pay more attention to the behavioral branch of economics. Behavioral economics has been increasingly recognized as an important way to understand microeconomic decisions of individuals, namely, what drives purchases apart from price and what makes investors take the risks they take. As a branch of economic thinking, it tells us that to fully understand how consumers and investors behave we need to include their motivations, their emotions and their social position. The clearest way to explain this has been through rigorous studies that showed people preferring to own the largest house in a small-house neighborhood rather than the smallest house in a large-house neighborhood. This defies normal consumer preference theories that most people would prefer the absolutely larger rather than relatively larger house. This point is now at the center of David Brooks' new book, *The Social Animal*, which emphasizes the gut instinct in decisions.

Why is this intensely relevant for macroeconomic policy and for economic growth going forward? Beginning with the stimulus packages of 2009, the great debate—in the United States, at least—was whether or not consumers would respond to tax breaks and whether new expenditures that increased national indebtedness lead to greater aggregate demand. Economists argued about the size of the multiplier, namely, the increment in income derived from additional government spending. Some thought that individuals did complex calculations about indebtedness and future obligations to service that debt. Others assumed that incremental income would be immediately spent since the recession had reduced disposable incomes for many. In the end it came down to confidence, however.

Past estimates of the size of the multiplier in normal times were not a useful guide for policy during an unusually deep and pervasive recession. Ironically in the United States, it took a measure that restored tax breaks for the wealthy to restore confidence among the non-wealthy. Counter-intuitive, perhaps, but not to behaviorists! When shocks are severe, models predicated on behavior in normal times are of limited use. This is a second dramatic lesson of the Great Recession. This point came across clearly in a March 7-8 conference hosted by the IMF in Washington and attended by numerous Nobel laureates and global policymakers. One of its sponsors, Chief Economist of the IMF Olivier Blanchard, admitted that the models had failed and that the economics profession's understanding of what instruments worked needed recalibration.

As speakers lamented the failures of markets that were unregulated, others lamented the elegance of economic models over their usefulness. As Joe Stiglitz noted, markets were never efficient and risks were never well managed; in a period of cheap credit and rapid growth, however, much can be swept under the rug. According to Bob Solow, fiscal policy was hampered by uncertainty and monetary policy became so loose that it, in essence, became a quasi-fiscal tool. Nothing seemed to work to restore confidence. A financial meltdown had become an economic meltdown, at least in the United States, still the largest economy in the world and the epicenter of expectations.

What does this imply for future growth? First and foremost, as Mike Spence pointed out, the Great Recession was not distributionally neutral, especially in the U.S., where the top 1 percent of income earners had already seen their share of national income rise from 9 percent in 1978 to 23.5 percent in 2007 before the crisis. If your neighbor loses a job, will you respond to a tax incentive or will you save more? What does your gut tell you to do, would be David Brooks' question. The American public refused to believe that the worst was over, particularly when unemployment was still sky high.

This leads to the final question of how long it will take to restore confidence. According to Reinhart and Reinhart, the aftershock of the recession may last a decade. According to Reinhart and Rogoff, when debt levels exceed a magical 90 percent of GDP, countries face significantly lower growth rates than otherwise. Both studies are based on historical and rigorous analysis. This is sobering. However, both rely on average reactions to normal, historically adverse circumstances. Behaviorists might argue that there are gut feelings on the upside as well, and that we may be in for a pleasant surprise as individuals reckon that a once-in-a-lifetime event has passed. Whether that is true or not remains to be seen. But one thing is sure: policymakers can no longer be quite so comfortable using mechanical response calculations that ignore the intangibles of decision-making. ■

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