

Week 11: Externalities, II: Government Failure

- I. The Reality of Government Policy
 - A. Real-world governments barely use Pigovian taxes or subsidies.
 - B. Counterexamples?
 - 1. Sin taxes
 - 2. Gas taxes
 - 3. Cost-sharing for artificial lawns, solar panels, etc.
 - 4. Toll roads
 - C. If they see social problems, governments usually respond with a massive body of detailed regulations or outright prohibition.
 - 1. Carbon taxes versus carbon policy
 - 2. Drug policy
 - 3. Worker safety
 - 4. HOV
 - D. If they see unrealized social gains, governments usually respond with direct ownership and giveaways.
 - 1. K-12
 - 2. National health care
 - 3. National highway system
 - E. The world's most Pigovian country: Singapore.
 - F. What's the harm? Massive efficiency losses. Pigovian taxes deliver much better results than the status quo.
 - 1. Indeed, the status quo could easily be worse than doing nothing, even when there are large externalities.
 - G. When they do charge, governments rarely try to set market-clearing prices.
 - 1. Traffic
 - 2. Parking
 - H. Worse yet: Governments make little effort to measure externalities, or even get the sign right.
 - 1. Education and credential inflation
 - 2. Delaying vaccines
 - I. Critics of markets often use Pigovian logic to condemn markets in theory. But Pigovian logic also condemns government in practice, because zero governments are even close to Pigovian.
- II. What Goes Wrong: The Logic of Decisiveness
 - A. People usually blame bad policies on lack of democracy. But Pigovian taxes and subsidies are almost non-existent even in democracies.
 - B. Why is this so? Almost certainly because the status quo is much more popular than the Pigovian alternative.

- C. This is not a local or short-lived problem. No earthly government in recorded history has been close to Pigovian.
 - D. Economics and common-sense tell us that for all their faults, people aren't complete fools. Can they really be complete fools in politics?
 - E. I say yes, because of a key asymmetry between markets and politics.
 - 1. In markets, if you figure out a better approach, you can adopt it and improve your life.
 - 2. In politics, if you figure out a better approach, you can't adopt it unless you convince a majority of voters first.
 - 3. Have you ever convinced a majority of voters of anything? I haven't.
 - F. But doesn't "every vote count"? Only microscopically. The chance that your vote flips an electoral outcome, also known as the "probability of decisiveness," is roughly 0.
 - 1. Mathematically: $p \approx 0$
 - G. The chance that your decision changes the contents of your shopping cart, in contrast, $p \approx 1$.
 - H. Selfishly speaking, what happens if you vote randomly – or emotionally?
 - 1. The same thing that would have happened otherwise!
 - I. Since voters' probability of decisiveness is roughly 0, people make little effort to think rationally about politics.
 - J. Instead, they respond emotionally. In markets, self-interest gives you strong reasons to control your emotions; in politics, the opposite is true.
 - K. Lesson: Politics isn't a grocery market; it's a common pool. We all throw our intellectual garbage into the pool, even though it's our sole source of drinking water.
- III. SDB and Politics
- A. Reminder: SDB= "Social Desirability Bias"; CBA= "Cost-Benefit Analysis."
 - B. What happens if the whole electorate votes emotionally? SDB crushes CBA!
 - C. Look at political arguments. CBA plays almost no role. All sides just try to say what sounds good – and goad their opponents into saying what sounds bad.
 - D. What economic ideas sound good to typical voters? To start:
 - 1. Blaming markets
 - 2. Blaming foreigners
 - E. More generally: On any policy issue, both sides try to sound good, with almost no measurement or math – practically the definition of "demagoguery." Examples:
 - 1. Tariffs
 - 2. Education
 - 3. FDA

4. Carbon emissions
5. Immigration
- F. When policies don't match CBA, apologists often say, "People just care more about equity." But migration patterns show this apology is largely SDB, too!
 1. How so? Because material well-being is a *much* better predictor of migration than any measure of "equity."
 2. Lots of California Democrats moved to Texas.
 3. The Gulf monarchies have no trouble attracting migrants.
- G. Unlike rhetoric, actual policies have to use at least *a little* measurement and math. Resources are finite and there are multiple problems, so no government actually "Does everything possible" for any one problem.
- H. Still, SDB is a *vastly* stronger predictor of actual policy than CBA.
- IV. Action Bias and Politics
 - A. When was the last time you heard a politician say, "We should do nothing about this problem"?
 - B. "We should do something" may sound like common sense, but it's not. What should you do about mosquito bites, for example? Leave them alone.
 - C. In psychology, the technical name for our urge to "do something" is "Action Bias." While you can easily think of it as a special case of SDB, it's so pervasive in politics that it's worth a separate discussion.
 - D. When does CBA recommend "doing nothing" about a problem?
 1. When you are extremely ignorant about how to help.
 2. When you know that helping is very costly.
 - E. In politics, however, it is extremely unusual to argue:
 1. "We don't know how to help, so let's do nothing until we learn more."
 2. "We could solve this problem, but the cost is too high."
 - F. Even if we're doing something, Action Bias pushes us to do *more* when any new problem emerges. CBA says this is a silly presumption.
 1. Ex: If you get into one car accident in ten years, does this show you should change your driving habits? Maybe one accident per decade is optimal.
 - G. Action Bias also pushes us to design bespoke "solutions" for every notable problem. E.g., instead of just giving the poor money for necessities, have separate programs for food, housing, and energy assistance.
- V. Availability Cascades
 - A. Closely related: Kuran-Sunstein's "availability cascades" model of mass hysterias and political crusades.
 - B. Cognitive psychologists have found that people frequently estimate probabilities based upon *how easy it is to think of examples*.

- Psychologists call this the “availability heuristic.”
- C. This often leads to systematically biased estimates. Psychologists call this “availability bias.”
 - D. This bias is normally demonstrated in simple experiments. How does it play out in the real world?
 - E. The cycle of hysteria:
 - 1. The media gives massive coverage to shocking but rare events in order to get good ratings.
 - 2. The public watches. Watching makes it easier for the public to think of examples of the events the media covers.
 - 3. One effect: The public begins to think the problems are quantitatively serious, so it gets easier to sell the public similar stories.
 - 4. Other effect: Politicians begin trying to solve the “problem” to win votes.
 - F. Examples:
 - 1. Nuclear power
 - 2. Genetically-altered food
 - 3. School shootings
- VI. The Ubiquity of Government Failure
- A. The Pigovian framework highlights endless ways for markets to fail CBA, then provides a recipe for governments to design remedies that pass CBA.
 - B. This often leads economists and other social scientists to defend almost all of government’s current activities, plus many more.
 - C. To repeat, however: No government on Earth is remotely Pigovian!
 - D. Governments don’t use CBA to decide whether markets fail. Instead, they use SDB: Does market performance *sound* good?
 - E. Governments don’t use CBA to decide how to “fix” markets, either. Instead, they use SDB: Does this remedy *sound* good?
 - F. The problem: CBA shows that lots of good stuff sounds bad, and lots of bad stuff sounds good. So real-world government actions routinely fail CBA.
 - G. Or so I claim. In our last two classes, I’ll defend two radical policy reforms where SDB currently crushes CBA.