Getting Microeconomic Policy WRONG: How to Break Economists’ Rules

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Economists' (Naïve) Rules for Efficient Policy

- If markets are competitive (which I’ll assume), agents are well-informed, and there are no spillovers (externalities), **do nothing**

- If some agents lack information necessary to pursue their objectives effectively, **provide the necessary information**

- If some activity engaged in by some agent imposes spillover costs (or benefits) on other agents that are not reflected in market prices, **tax (or subsidize) the activity causing the spillovers**
  - *If no related distortions*, the tax (or subsidy) should in equilibrium equal the net external cost (or benefit) caused by the activity

- **Politicians have found MANY clever & interesting ways to break these naive rules in energy and environmental policy!**
Pick the Wrong Target: CAFE Standards

• Does driving gasoline/diesel vehicles impose net spillovers?
  • More use of imported oil may make national security more expensive; driving causes congestion and environmental damage
  • Enviro+tax policy may not impose all external costs on drivers

• If so, oil use in motor vehicles is the natural target, and the taxes on gasoline and diesel fuel should be raised

• Instead, mileage standards on new cars and light-duty trucks
  • Invite category gaming (minivans & SUVs), ignore heavy-duty trucks
  • By making new vehicles more expensive, reduce the incentive to scrap old, less efficient vehicles
  • Reduce the per-mile cost of driving, thus encourage driving
  • Hide the policy’s cost: vehicle prices rise, relative prices of high-mileage & low-mileage vehicles are distorted; car companies blamed
Other Popular Techniques I

• **Assume consumers are idiots:** decide for consumers (e.g., appliances), don’t try to give information in useful ways
  • **But:** consumers sometimes *are* idiots, information may not work

• **Invent the science you need:** assuming thresholds in criteria air pollutants forces regulators to ignore costs & benefits

• **Regulate only new pollution sources (w/o votes):** raises incentives to keep old, dirty sources operating forever

• **Require particular technologies:** removes *all* incentives to innovate, results of legislating technology not good (ethanol)

• **Impose performance standards:** better, but no incentive to beat the standard, typically focuses on junk/output v. junk
Other Popular Techniques II

- Assume learning-by-doing solves everything: but learning ≠ spillovers, spillovers from basic research (e.g., photovoltaics)
- For learning, subsidize input (e.g., capacity), not output: reduces incentives to learn to produce output efficiently
- Believe in “technology forcing”: 80% cut in CO₂ by 2050?!?!?
- Use command & control to hide costs: consider ethanol, GPF standards, or RPSs w/o nuclear or hydro
- Keep subsidies hidden too: impose usage requirements, don’t make CA water rights tradable
- Use other distortions as an excuse: assume all brown activity under-taxed, use to rationalize subsidizing anything green
But Seriously, Folks

• These “techniques” are often politically rational; a socially superior policy may lose to special interests (e.g., ethanol in 1990)

• But sometimes the search for more efficient policy does pay off:
  • What EXACTLY is the problem? Often the most important question and the hardest to get into the debate – e.g., CAFÉ v. gasoline tax
  • How can we give the private sector strong incentives to solve the problem at least cost? Often involves prices or tradable rights
  • Are there ways to use information to improve private decisions rather than pre-empting them by command and control regulation?
  • For technology development, are learning-related spillovers likely to be sufficient, or do we need to fund new basic research?
  • Is there an inexpensive way to buy off special interests? (e.g., by grandfathering rights)