



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 \neq 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)