Macroeconomics is, of course, much more difficult. The data base remains grossly insufficient (partly because of excessive concerns about confidentiality which has remained a baleful influence on academic advances throughout economics) and far more inaccurate than most economists realize. We cannot undertake controlled experiments. Even if we could, individuals learn from such outcomes and adapt their behavior. The alternatives range between rough-and-ready regression exercises without much theoretical basis (of which simple Vector Auto-Regressions, VARs, are an extreme form) to formal models that introduce an abstract, "deep," theoretical purity at the expense of institutional reality. None of the above approaches has much claim to be scientific.

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THE ECONOMIST AS PUBLIC INTELLECTUAL:
A CASE FOR SELLING PARETO IMPROVEMENTS

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Like Dan Klein, I have always been puzzled by George Stigler's stubborn insistence that economists steer clear of public policy debate. I am equally puzzled, however, by Klein's highly circumscribed vision of the economist's role in that debate. In essence, he urges us to moonlight as ghostbusters on search-and-destroy missions against rent-seeking.

This is a noble task, to be sure. Rent-seekers impose costs on us in virtually every sphere of public endeavor, and shaming more of them into retreat would be a good thing. Yet the line's share of missed public-policy opportunities have little to do with greed or rent-seeking. They stem, rather, from simple ignorance of economic facts and logic. To an extent that many economists fail to appreciate, ignorance of this sort is a hard target, one that is highly vulnerable to attack by the economist as public intellectual.

The history of tradable environmental emissions permits provides an instructive case in point. When early environmental legislation called for across-the-board emission reductions from all sources in the 1970s, economists objected that this approach was inefficient. The problem is that it takes no account of the fact that emissions can be curtailed at little cost in some activities, but only at great cost in others. And since society's interest is to reduce pollution at the lowest total cost, we should concentrate the cleanup effort in the hands of those for whom this effort is least costly. Yet early environmental legislation, with its call for across-the-board cutbacks, made no attempt to do so.

As an alternative to this legislation, economists proposed the auctioning of tradable emissions permits, a highly decentralized, non-bureaucratic approach that would send just the right signals for efficient environmental cleanup. Because no activity could emit pollution without a permit, those engaged in activities with high cleanup costs would find it attractive to buy permits and continue to pollute. In contrast, those whose cleanup costs would do best by switching to cleaner methods.

Critics were outraged at first, charging that the proposal would "allow rich corporations to pollute to their heart's content." Environmental pollution, in their eyes, was an immoral act, and here economists were proposing to allow purchasers of emissions permits to do it with impunity! This objection proved rhetorically powerful, effectively forestalling adoption of the auction proposal for nearly two decades.

The waste that resulted from the command-and-control environmental regulation that continued in the meantime had nothing whatsoever to do with rent-seeking.

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Rather, it happened simply because critics didn't understand the economic logic behind tradeable emissions permits. If economists had followed Georg Stigler's exhortation to steer clear of policy debate, we would still be stuck with the command-and-control approach. We may be thankful, therefore, that proponents of the auction approach held their ground, patiently explaining why critics' objections were misguided.

Firms pollute, they said, not because they derive perverse pleasure from doing so, but because clean production processes are more costly than dirty ones. Firms face competitive pressure to keep costs as low as possible, which in the old days meant ignoring the external costs of pollution entirely. Economic theory—the simple kind whose usefulness Dan Klein rightly emphasizes—tells us that if we are to reduce pollution at the lowest total cost to society, marginal abatement costs must be the same for all pollution sources. Economists explained why tradeable emissions permits would ensure precisely that result—because each firm would continue to curtail pollution until its marginal cost of abatement rose to the price of an emissions permit. The beauty of the permit auction, in short, is that it would nullify the perverse incentives that gave rise to excessive pollution in the first place. It doesn't prescribe specific technologies; it doesn't mandate the use of specific types of fuel; and it makes no attempt to regulate output directly. It just changes the relevant price signals, then leaves everything else up to decentralized market incentives.

As compelling as these arguments might seem, they did not quickly defeat opposition to the auction proposal. With remarkable perseverance, however, economists pelted successive waves of environmental policy professionals with the same arguments year after year. And the election of each new Congress brought more legislative assistants to the Hill who, as students, had been exposed to these arguments in their academic careers.

As a result, the idea of a market for effluent permits gradually came to seem less radical, less outrageous. In a move that would have been unthinkable a decade earlier, Congress passed the Clean Air Act of 1990 with a specific provision calling for marketable permits for emissions of SO\(_2\). Firms lacking these permits would simply not be permitted to emit any SO\(_2\), an important precursor of acid rain.

Shortly after its implementation in 1996, this provision became one of the most remarkable success stories in the history of the environmental protection movement. In 1996, Resources for the Future estimated that the Environmental Protection Agency's targeted annual reduction of 10 million tons per year in SO\(_2\) emissions would cost only $0.87 billion to achieve each year, less than one-fifth as much as the EPA itself had estimated in 1990 [EPA, 1999].

Although it was once difficult even to discuss the idea of tradeable emissions permits in polite company, today one hears scarcely a whisper of protest about the fact that the Chicago Board of Trade conducts an annual auction for such permits. Similarly, few complain about the brisk after-market in which emissions permits are now traded on a daily basis. Indeed, the same environmental activists who were once so outraged by the auction proposal now maintain websites that explain how, for about $130, concerned citizens can purchase a 1-ton SO\(_2\) emissions permit and simply rip it up, thus "buying pollution right out of the sky" [The Acid Rain Retirement Fund]. The Clean Air Conservancy, for example, announces with obvious pride that it has retired over 3,000,000 pounds of SO\(_2\) since the tradeable emissions program was adopted [The Clean Air Conservancy].

As this brief history suggests, economists can provide valuable counsel on important questions of public policy. That by itself is a good reason for us to engage in public policy debate. But Dan Klein is right when he notes that such engagement often entails professional costs. Those who would follow this path should thus pick their targets wisely. Klein urges us to make war on rent-seekers. But although the waste they cause is a legitimate target, waste caused by ignorance is a far riper one for several reasons.

Most important, an attack on such waste plays to our comparative advantage. Knowledge of economic facts and logic is our long suit, a powerful weapon against ignorance. In contrast, our particular mix of skills is not at all well-adapted to battle against rent-seeking, which is seldom a matter of ignorance. Everyone knows, for example, that a highway to nowhere in West Virginia is not a good use of public funds; yet this knowledge doesn't always prevent a powerful senator from getting it built. Effectively to oppose rent-seeking requires real political muscle—a commodity in short supply among economists. Yes, we can help call attention to the waste caused by pork-barrel spending; but so can journalists, who are generally much better equipped to do it than we are. And unlike rent-seeking, which has been under more or less constant attack since human societies first started governing themselves, the attack on waste resulting from economic ignorance is relatively new—much of it relying on theories and evidence still under refinement. An abundance of low-hanging fruit remains.

Consider, for example, the potential gains to be had if Congress could be persuaded to address the distributional concerns that currently inhibit more widespread reliance on cost-benefit analysis in public decision-making. The underlying economic argument for cost-benefit analysis rests on the use of willingness to pay for measuring the relevant costs and benefits. Critics object that because willingness to pay is based on income, cost-benefit analysis assigns unjustifiably large decision weight to high-income persons. In pursuing their point, these critics invoke the theoretically powerful claim that everyone's preferences regarding policy decisions deserve the same weight, irrespective of income. As citizens, they ask, aren't we all equal in the eyes of the law? Yet despite the obvious rhetorical force of the critics' case, economic analysis reveals its fundamental flaw, one that can be seen clearly in the context of a simple example.

Consider a hypothetical community with three voters—one rich, the other two poor. Up for decision is a proposal to switch the local public radio station from an all-music format to an all-talk format. The rich voter would be willing to pay $100 to see this change enacted, while the poor voters would be willing to pay $10 each to prevent it. If each voter's interests are weighted equally, the vote will be 1 to 1 against the switch, which will therefore not be adopted. Yet in cost-benefit terms, failure to switch results in a net loss of $80. Under the circumstances, little ingenuity is required to design a proposal that would command unanimous support. The switch could be made on the condition, for example, that an additional $80 in taxes be levied on the rich voter, which could
than be used to reduce the taxes of each poor voter by $250. Relative to the alternative of not switching, a switch made on these terms would generate a net gain of $600 for the rich voter, and a net gain of $150 for each of the two poor voters.

Critics typically respond that although such transfers would be fine in principle, the poor lack the political muscle to get them. Politicians may pay lip service to the need for compensation, but then never come through in the end. In such a world, critics argue, we get better results by resolving conflicts on a one-person, one-vote basis. That may be inefficient, they concede, but if we care about fairness, it’s still a better result.

As persuasive as this argument may sound, however, it cannot withstand economic scrutiny. If the poor lack the political power to bargain for compensation in return for supporting a policy that harms them, what gives them the power to block that policy in the first place? As the example shows, after all, exercise of such power would be far more costly to the wealthy than granting compensation. If the poor have somehow acquired that power—which, in the example, rests in their ability to block projects with a majority vote—then they necessarily have the power to bargain for compensation. The reason is that any policy that passes the cost-benefit test but creates net losses for the poor can be transformed into a Pareto improvement by simply making the tax system more progressive. That would not be a complicated task. Nor is there persuasive evidence that a marginal increase in the progressivity of the U.S. tax system would cause significant efficiency losses [Frank, 1999, Ch 15].

Critics of cost-benefit analysis are correct that using unweighted willingness-to-pay measures virtually assures a mix of public programs that are slanted in favor of the preferences of high-income persons. Yet rejecting programs that pass the cost-benefit test cannot be our best response to that concern. A far better alternative would be to use unweighted willingness-to-pay without apology, and then use the tax and transfer system to compensate low-income families ex ante for any resulting injury. It would be neither practical nor desirable for this compensation to occur on a case-by-case basis. Instead, we could grant low-income persons not just the transfer payments and tax breaks required by distributive justice under current arrangements, but also additional compensation reflecting their expected losses from use of cost-benefit analyses based on unweighted willingness-to-pay.

My point is not that granting additional political power to the poor would be a bad idea. Rather, it is that abandoning cost-benefit analysis is a gratuitously wasteful way of trying to achieve that goal. Rich and poor alike have an interest in making the economic pie as large as possible. Any policy that passes the cost-benefit test makes the economic pie larger. And when the pie is larger, everyone can have a larger slice.

Yet distributional concerns continue to block welfare-enhancing moves in a host of important policy areas. For example, they make lawmakers reluctant to abandon wasteful programs such as rent controls, commodity price supports, and energy subsidies. And they prevent lawmakers from adopting other measures that would improve overall efficiency, such as taxes on congestion and fossil fuels, or broader free-trade agreements. Addressing the distributional concerns that stand in the way of change would unleash Pareto improvements of considerable magnitude.

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