

# On Fairy Tales

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*Cass R. Sunstein\**

Consider the following tales:

1. In the Great Society, government officials are well-informed, well-motivated, and very wise. They are not vulnerable to the power of self-interested private groups. They are fully able to correct market failures, to produce optimal redistribution, and to promote public aspirations.

2. In Olympus, federal judges are especially good at moral and political philosophy. When they are asked to think about the rights that people have, they are unerring. They understand that self-government is among the relevant set of rights. They always respect self-government, properly understood.

3. In Benthamville, regulators have hedometers; they are able to measure with perfect accuracy the welfare effects of various policies. In a neighboring city, Aristotleton, regulators have eudiameters,<sup>1</sup> with which they can measure with perfect accuracy the effects of regulatory policies on human flourishing.

4. In Paretoville, people do not lack information or suffer from bounded rationality. Their willingness to pay (WTP) for a specific good perfectly captures the welfare that they would receive from that good. The citizens of Paretoville certainly care about the well-being of others, especially their own children, and their WTP fully reflects their concern. In Paretoville, there are no externalities and no collective action problems.

No one lives in the Great Society, Olympus, Benthamville, Aristotleton, or Paretoville. What's the point of talking about them? In their generous and instructive essay, Heinzerling and Ackerman object that Paretoville is so ludicrously different from our world that we would do better not to think about it.<sup>2</sup> In their view, “[p]ublic policy involves public goods and universal regulations, adopted in a world of imperfect competition, limited information, and pervasive externalities.”<sup>3</sup> They believe that Paretoville is a “peripheral case at best, distracting us from the real-world circumstances in which debates over the utility of WTP arise.”<sup>4</sup>

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<sup>1</sup> So-called on the basis of the Aristotelian notion of eudaimonia. See MARTHA NUSSBAUM, *THE FRAGILITY OF GOODNESS* (2d ed. 2001).

<sup>2</sup> Lisa Heinzerling & Frank Ackerman, *Wasting Away in Paretoville*, 1 HARV. L. & POL'Y REV. 363, 364 (2007) [hereinafter Heinzerling & Ackerman, *Wasting Away*].

<sup>3</sup> See *id.*

<sup>4</sup> *Id.*

Heinzerling and Ackerman are right to emphasize that the real world is very different from Paretoville. But it is less clear that Paretoville should be regarded as a distraction—any more than the assumption of zero transactions costs is best regarded as a distraction,<sup>5</sup> or than the assumptions in the tales of the Great Society, hedometers, eudaimeters, and Olympian judges are a distraction. To make progress on social questions, fairy tales and thought experiments can be exceedingly helpful, because they assist in the analysis of problems that are otherwise impossibly large. With an understanding of how to proceed in the face of zero transactions costs, we will know a great deal more about how to proceed when transactions costs are positive. With an understanding of what officials should do in the Great Society, we will be in a better position to explore what they should do in a pretty good society. If we do not want judges to proceed as they would in Olympus, an understanding of Olympus will make questions about appropriate behavior far more tractable. If we know what regulators should do with hedometers or eudaimeters, then we will know more about what they should do without them.

The more particular point is that there is a complex relationship between individual choices on the one hand and individual and social welfare on the other hand, and we cannot make much progress unless we unpack that relationship. The analysis of Paretoville, and of how it is different from reality, helps to establish three propositions: (1) welfare is what matters, not wealth maximization; (2) wealth redistribution might be justified even if is inefficient;<sup>6</sup> and (3) people sometimes make choices that reduce their welfare. Heinzerling and Ackerman accept these propositions, and argue that our shared beliefs on these counts leave Paretoville as “a tiny speck in the rearview mirror,”<sup>7</sup> which is very plausibly true.<sup>8</sup> But without Paretoville, it is unclear we would be able to get far down the road. It is possible to learn a lot from fairy tales.

In the end, Heinzerling and Ackerman object to talk of Paretoville because they object to WTP as an inadequate measurement of what matters. Since my paper mounts a challenge to WTP on exactly that ground, it is unclear that we have much to disagree about. To be sure, Heinzerling and Ackerman are right to I say that I am a defender of cost-benefit analysis using WTP figures.<sup>9</sup> However, the defense operates on the ground that cost-benefit analysis provides relevant information about what really matters, which is welfare.<sup>10</sup> Governments lack direct measures of welfare; outside of fairy

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<sup>5</sup> See Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

<sup>6</sup> I am understanding efficiency here in the sense of wealth maximization, or potential Pareto superiority with the relevant values defined in terms of money rather than welfare.

<sup>7</sup> Heinzerling & Ackerman, *Wasting Away*, *supra* note 2, at 370.

<sup>8</sup> In some cases, Paretoville is more artificial than in others. See Cass R. Sunstein, *Will-  
ingness to Pay vs. Welfare*, 1 HARV. L. & POL'Y REV. 303, 308 (2007) (discussing workers'  
compensation programs and Safe Drinking Water Act).

<sup>9</sup> See, e.g., CASS R. SUNSTEIN, *RISK AND REASON* (2002).

<sup>10</sup> A sustained defense of this position can be found in MATTHEW ADLER & ERIC POS-

tales, they do not have hedometers or (what would be better still) eudiometers. But sometimes regulators are able to calculate and to monetize the costs of their actions, and sometimes they can do the same with the benefits.

Because we are not in Paretoville, the welfare effects of any regulation will not be adequately captured by the monetized benefits and costs. But with an understanding of Paretoville, we will be able to identify some of the right questions: (a) Who, exactly, is helped, and who is hurt? (b) What exactly does a significant monetary loss mean? Will it produce mortality risks of its own? (c) Do people's WTP reflect an absence of information or some kind of bounded rationality? (d) Are there third-party effects not captured by the cost-benefit analysis?

Consider in this regard the problem of climate change, which is of evident concern to Heinzerling and Ackerman.<sup>11</sup> It would be silly to say that the proper policy should be set by calculating the world's WTP for the benefits of mitigation and adaptation strategies, and by comparing that WTP to the costs. (The tale of Paretoville helps to show why.) But it is hardly ludicrous to say that policy judgments should attend carefully to the costs and benefits of the various options. The argument for taking aggressive steps to control ozone depletion was greatly strengthened by cost-benefit analysis, which demonstrated that the benefits dwarfed the costs.<sup>12</sup> If climate change can be expected to do little damage, then the argument for expensive mitigation strategies is surely weakened. If adaptation is much less costly than mitigation, and can achieve the same level of benefits, then much is to be said on behalf of adaptation. If climate change is expected to cut the gross domestic product of rich nations by 5%, and of poor nations by 10%, then expensive precautions are surely justified.<sup>13</sup> Because emissions trading programs are likely to reduce the costs of mitigation significantly, such programs promise a far better cost-benefit ratio than imaginable alternatives.<sup>14</sup> Other things being equal, they should be preferred for that reason.

But my goal here is not to defend cost-benefit analysis, even on the modest ground that it provides relevant information about what matters, which is the welfare effect of various policies. My claim is simpler and (I hope) less contentious: If we are able to learn something from the tales of

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NER, *NEW FOUNDATIONS FOR COST-BENEFIT ANALYSIS* (2006); in the same vein, see CASS R. SUNSTEIN, *WORST-CASE SCENARIOS* (2007).

<sup>11</sup> See Lisa Heinzerling & Frank Ackerman, *Law and Economics for a Warming World*, 1 HARV. L. & POL'Y REV. 331 (2007).

<sup>12</sup> See Cass R. Sunstein, *Of Montreal and Kyoto: A Tale of Two Protocols*, 31 HARV. ENV. L. REV. (forthcoming 2007).

<sup>13</sup> See NICHOLAS STERN, *THE STERN REVIEW, THE ECONOMICS OF CLIMATE CHANGE* (2006), [http://www.hm-treasury.gov.uk/independent\\_reviews/stern\\_review\\_economics\\_climate\\_change/stern\\_review\\_report.cfm](http://www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm).

<sup>14</sup> See WILLIAM NORDHAUS & JOSEPH BOYER, *WARMING THE WORLD* (2000); STERN, *supra* note 13, at 351–62.

Benthamville and Aristotleton, then we can learn from the tale of Paretoville, too.