

Wasting Away in Paretoville: A Reply to Cass Sunstein

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In his article in this issue, Professor Sunstein asks a provocative series of questions.¹ What are the limits of the traditional approaches to welfare economics, which focus on the Pareto optimality of market outcomes and the use of willingness to pay (WTP) as the measure of the value of government regulation? What does equity, an inescapable concern in an unequal world, have to do with these market-oriented theoretical constructs? Does the recent empirical literature on subjective well-being, and on psychological anomalies, challenge our understanding of welfare?

The questions are excellent; the answers are less satisfying. While presenting selected useful pieces of a solution, Sunstein repeatedly falls short of assembling them into a coherent alternative to traditional welfare economics. If, as Emerson put it, a foolish consistency is the hobgoblin of little minds, then there are ample traces of a large mind at work here. Our comments, which are organized as responses to his four principal sections, generally argue for a more complete departure from the conventional economic theories which Sunstein (too gently and too partially) criticizes. We offer the comments in the spirit of Sunstein's own libertarian paternalism: we will not force him to accept the logical consequences of his own convictions, but we will try to nudge him in that direction.

I. PARETOVILLE IS A TINY HAMLET IN A BIG WORLD

Sunstein believes that WTP is useful only if it relates to human welfare. "There is no plausible argument," he concludes, "that WTP is important in itself."² If the relationship between WTP and welfare is weak, Sunstein concedes, "the use of WTP will often be vulnerable." Yet, Sunstein believes, WTP "makes a great deal of sense" in certain "core cases."³

Sunstein describes these "core cases" by imagining the city of Paretoville. Paretoville's residents belong exclusively to the species *homo econo-*

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¹ See Cass R. Sunstein, *Willingness to Pay vs. Welfare*, 1 HARV. L. & POL'Y REV. 303, 304 (2007).

² *Id.*

³ *Id.* at 306.

micus—well informed, self-interested, asocial people who wish solely to accumulate private consumer goods. They are, in addition, equally wealthy (or equally poor). In that world, Sunstein argues, WTP is the best measure of welfare.

There are many things wrong with this picture. Some are recognized by Sunstein himself. But some of its crucial flaws, as a model of reality, are barely touched on by him. One example is the assumption of impossibly extensive information. More realistic economic theories of limited information date back at least to the work of Herbert Simon,⁴ and have been prominent recently in the work of Joseph Stiglitz⁵—both of whom received the Nobel Prize in economics. In their models, the limited information available to market actors inevitably destroys the proof of optimality of market outcomes.

Paretoville is also unrealistically devoid of public goods—expenditures or decisions that are inherently collective. Sunstein mentions regulations that affect everyone, such as drinking water standards, but immediately focuses on their assumed monetary cost to individuals, as if they were private purchases. But public policy is rarely about individual purchases. Let us suppose that John would like to “buy” one Iraq war, while Cindy would like to “buy” zero. There is no “purchase” that can make them both happy, since they are clashing with each other over public goods (or bads).

In Paretoville there are also no externalities. One’s decisions affect only oneself. One can buy safe drinking water, or not, with no effect on anyone else. One can buy a reduction in risk, or health insurance, or apparently anything one wants, without worrying about whether one’s purchase has any effect on anyone else. Would that it were so.

Rather than (with apologies to Jimmy Buffett) wasting away in Paretoville, looking for that lost measure of welfare, it is time to sing a different tune. Public policy involves public goods and universal regulations, adopted in a world of imperfect competition, limited information, and pervasive externalities. In such a world, perfect competition and *homo economicus* are so far from reality that they are not even helpful analytical starting points. There is, in particular, no reason to think that market outcomes are usually optimal, or that government intervention is welfare-decreasing. Paretoville is not a “core case,” as Sunstein suggests; it is a peripheral case at best, distracting us from the real-world circumstances in which debates over the utility of WTP arise.

Even Sunstein does not really believe in Paretoville. The remainder of his article offers a long list of Paretoville’s deviations from reality. But

⁴ Simon’s publications in this area date back to the 1950s; for a relatively recent collection of his work, see HERBERT A. SIMON, *MODELS OF BOUNDED RATIONALITY* (1997).

⁵ See, e.g., Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, 92 *AMER. ECON. REV.* 460 (2002).

one of these deviations does not, at least in Part I, much trouble Sunstein, and that is the assumption of wealth equality. Even if, consistent with reality, some people in Paretoville were rich and some poor—even if, in Sunstein’s words, “Paretoville has a significant amount of inequality”⁶—we can still comfortably use WTP as a measure of welfare. Here, “WTP” morphs into “ATP” (ability to pay) without so much as a blink from Sunstein: if the poor would be *willing* to pay \$120 for health insurance but *able* to pay only \$60, he says, “government does them no favors by forcing them to pay the amount that they would pay if they had more money.” Better, Sunstein believes, to “give people more resources” than “to require people to buy goods on terms that they find unacceptable.”⁷ But unless we’re in Paretoville, the “terms” people find “acceptable” will be a poor measure of welfare without appropriate appreciation of imperfect information, public goods, and externalities.

II. EQUITY ALWAYS MATTERS

In his second section, Sunstein argues that one problem with using WTP to measure welfare is that “people do not always pay all or even most of the cost of what they receive.”⁸ Disabled workers do not always pay for workplace accommodations required by federal law; victims of air pollution do not always pay for the costs of reducing pollution. Sunstein goes on to explain that if the poor are benefited by a policy that will be paid for by the rich, it may be welfare-enhancing, even if inefficient, to adopt the policy—or better yet, he thinks, to redistribute income so that the poor can pay for the consequences of the policy they desire.

As Sunstein describes the problem, therefore, it is up to the people being hurt—the disabled, the breathers of dirty air—to pay to stop the harm. Sunstein nowhere mentions the possibility of turning the question around, asking how much the discriminators and polluters would pay to keep discriminating and polluting. Nothing in the theory of WTP tells us which of these questions to ask. In silently building into his discussion of WTP an assumption that the people being hurt must be the ones who pay to stop the hurting, Sunstein confirms the suspicions of many that WTP is no neutral policy instrument, but a one-way street to deregulation.

Moreover, if objective measures of welfare are superior to subjective measures, as part of Sunstein’s discussion implies and as we argue in the next section, then there is no basis for Sunstein’s unqualified view that redistribution rather than regulation is the best way to address social problems in the face of wealth inequality. If we believe that physical health is a better measure of welfare than accumulation of consumer goods, then we will be

⁶ Sunstein, *supra* note 1, at 308.

⁷ *Id.*

⁸ *Id.* at 308–09.

hesitant to conclude, with Sunstein, that environmental protection is a worse promoter of welfare than redistributive taxation is.

Sunstein must be applauded for recognizing the heretical notion that welfare can be improved by “inefficient” policies. But let’s consider the strangeness of the orthodoxy, relative to which this is heresy. Efficiency, in economic theory, is defined as Pareto optimality: a situation in which no one can be made better off without making someone else worse off. A further gloss on the same basic picture is the Kaldor-Hicks criterion, according to which an increase in output is always efficient, since it represents a “potential Pareto improvement”—with more total resources available, the winners could potentially compensate the losers so that no one would lose.⁹ Pareto optimality, of either the actual or potential variety, is famously insensitive to equity: it is equally optimal to have perfect equality of income, or perfect inequality. In fact, it has been mathematically demonstrated that an economy can be efficient even if resources are so unequally distributed that some market participants starve to death, and hence drop out of the market.¹⁰ This is consistent with Pareto’s own elitist, aristocratic political views,¹¹ but obviously incompatible with most ethical and religious beliefs and even mildly egalitarian political perspectives.

Pareto optimality becomes a useful standard of evaluation only if it is impossible to compare one individual’s welfare to another—or, in the jargon, to make “interpersonal comparisons of utility.” This is just what conventional economic theory has assumed, ever since the so-called “ordinalist revolution” of the 1930s.¹² Indeed, under the ordinalist interpretation of welfare, Pareto optimality is as far as one can go in ranking different economic outcomes. If one individual’s welfare cannot be compared to another, there is no way to know that a desperately poor person would receive more benefit from receiving \$20 from a rich person than the rich person would receive in keeping the money, and thus no “objective” argument for wealth redistribution.

Sunstein rejects the ordinalist approach in passing, asserting almost without comment, in a footnote, that he—entirely reasonably, in our view—assumes the possibility of interpersonal comparisons of welfare. But the effect of that commonsense assumption on economic theories of efficiency and Pareto optimality is similar to the effect on Tinkerbell when the children threaten to stop believing in her.

⁹ For our critique of the Kaldor-Hicks criterion, see FRANK ACKERMAN & LISA HEINZERLING, PRICELESS: ON KNOWING THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING 34–35 (2004).

¹⁰ See Jeffrey L. Coles & Peter Hammond, *Walrasian Equilibrium without Survival: Existence, Efficiency, and Remedial Policy*, in CHOICE, WELFARE, AND DEVELOPMENT: A Festschrift in Honor of Amartya K. Sen 32 (1995).

¹¹ See ACKERMAN & HEINZERLING, *supra* note 9, at 31–35.

¹² See Robert Cooter & Peter Rappoport, *Were the Ordinalists Wrong about Welfare Economics?*, 22 J. ECON. LIT. 507 (1984).

Add the further assumption that the same experiences should have equal welfare significance regardless of a person's income, as Sunstein implicitly does in his discussion of international comparisons, and one can justify at least a Scandinavian, if not a Bolshevik, level of income redistribution. Sunstein does not appear to realize that he has taken us to the brink of this entirely different and more compelling story about public policy and collective resources. In a world in which people are assumed to be comparable to each other, and equity always matters, the old economic theories can be kept alive only if we close our eyes and promise to keep believing in fairy tales.

Yet the old theories never quite fade from Sunstein's view. He concludes that the government of India should spend less on risk reduction than its counterparts in the United States or France, based on its citizens' differential WTP (or more precisely, ATP) for such measures. A more natural conclusion would be that the United States and France should greatly increase their aid to India to address the glaring international inequality in welfare. Sunstein does not mention this possibility; indeed, oddly, he thinks it "impossible to redistribute from wealthy nations to poor ones."¹³ And, outside the international context, he cautions that redistribution could produce "harmful incentives" or "remove desirable" ones—a familiar but undocumented claim. It is worth recalling that from 1950 through 1963, the portion of a household's income above \$400,000 (equivalent to about \$3 million in today's prices) was taxed at 91%.¹⁴ Despite this crushing damper on incentives for the rich, the U.S. economy grew by 3.7% per year in that period, well above its more recent average.¹⁵

III. EGALITARIANISM REQUIRES OBJECTIVE MEASURES OF WELFARE

When he turns to definitions of welfare in Part III, Sunstein presents two very different standards—objective and subjective measures of welfare—with almost no comment on their relationship. Yet a decision between these two flows directly from his presumption in Part II that it is possible to compare the welfare of different individuals and that death or other major harms should have broadly comparable weight regardless of who experiences them. Within this egalitarian framework, only an objec-

¹³ Sunstein, *supra* note 1, at 315.

¹⁴ The first \$400,000 of income was taxed at lower rates, and the total tax burden on a household was capped at 87%. National Taxpayers Union, *History of Federal Individual Income Bottom and Top Bracket Rates*, <http://www.ntu.org/main/page.php?PageID=19> (last visited Mar. 9, 2007).

¹⁵ Authors' calculation of average growth rate of real GDP, 1950–1963, based on data from the Bureau of Economic Analysis. See Bureau of Economic Analysis, *National Income and Product Accounts Table 1.1.6, Real Gross Domestic Product*, <http://www.bea.gov/bea/dn/nipaweb/index.asp> (last visited Mar. 9, 2006). The same source shows real GDP grew at an average of 2.4% from 2000 through 2005, years in which the top income tax rate was below 40%. See *id.*

tive measure of welfare makes any sense. The work of Amartya Sen and Martha Nussbaum, cited by Sunstein, is a major step in this direction. As Sunstein notes, discussing their work, it should not matter for welfare purposes that a person with ample resources has “learned” to want more, even to be unhappy without more, while a person with limited opportunities has learned to want little, and be happy with a pittance.

It is hard to see what WTP could contribute to an objective approach to welfare. If WTP is meaningfully connected to ability to pay, then the rich will have greater WTP for trifles than the poor will have for necessities. Conceivably, an argument could be made for the welfare significance of WTP expressed as a percentage of income; we are not, however, aware of anyone who has made this proposal. But without some such income scaling, any WTP measures, such as those created in contingent valuation studies, simply reflect and reinforce existing inequalities. This is another expression of our point in the previous part, namely that the acceptance of interpersonal comparisons and egalitarian assumptions about welfare are radically destructive of conventional economic theories.

The new area of survey research on subjective well-being, or self-reported happiness, has a similar relationship to the whole discussion. Surprisingly, this research shows that most people have a strong tendency to revert to a pre-existing personal baseline level of happiness, not long after what seem like extraordinarily good or bad changes in their life circumstances. Sunstein first presents thoughtful criticisms of the applicability of subjective well-being to discussions of welfare, then shifts into suggesting an emphasis on “happiness or self-reported welfare” as an alternative goal that could replace economic growth and conventional measures of welfare.

It should be clear, however, that interpersonal comparison and egalitarianism do not allow self-reported happiness to be a measure of welfare, any more than WTP. The problem is again the status of the person who has learned to want too little, or too much, based on past experience in an unequal world. Perhaps, as apologists were wont to claim, some slaves were happy serving their masters in the antebellum South. This did not refute the case for abolition.

IV. YOU CAN'T (AND SHOULDN'T) ALWAYS GET WHAT YOU WANT

Sunstein's final section presents a range of observations on the puzzles of “miswanting”—the common phenomenon of wanting things that will not make you happier when you get them, and of misjudging, in general, what it is that makes you happy. People are overly reactive to their immediate context (Section A), often suffer from excessive optimism (B) or myopia (C), and are subject to a variety of focusing illusions (D). The phenomenon of miswanting is familiar to parents everywhere, who routinely confront children's desires for things that would not lead to greater

happiness if acquired or allowed. And it is the motivation for prohibitions of dangerously addictive drugs. The puzzles of miswanting pose a challenge to the simplest versions of utilitarianism, demonstrating that welfare should not be based on instantaneous, self-reported happiness. But it is a less fundamental challenge than the issues raised by egalitarianism and interpersonal comparison.

To the extent that people are aware of miswanting, it can be addressed in theory through rule utilitarianism. This perspective was raised in economics by the late John Harsanyi, who advocated informed choices of the rules that generally lead to maximizing welfare, not individual calculations of welfare resulting from each act.¹⁶ Thus Social Security and other mandatory retirement programs prevent people from forgetting to save for their old age; prohibitions on child labor, and on dangerous work for all ages, prevent people from making choices that they may later regret in pursuit of short-term income.

To the extent that people are not aware of miswanting, a deeper exploration of social psychology is required. This might lead into questions of advertising and the media it supports, the formation of fads and fashions, and the systematic and profitable creation of miswanting for advertised products – but that stretches far beyond the scope of the current discussion.

Sunstein is again of two seemingly opposed minds on this question. On the one hand, he reiterates that WTP is not a good measure of welfare in the presence of miswanting. On the other hand, he offers a bizarre speculation about the implications of self-reported happiness as a standard: if people are not made permanently less happy by major injuries, perhaps the damages awarded by juries are too large! If it is the case, as empirical research suggests, that no permanent change in happiness results from losing an arm, *and* if self-reported happiness is the only standard that matters (as Sunstein sometimes implicitly suggests and sometimes explicitly denies), then there is no need to compensate those who lose arms (or at least we should be very careful not to compensate them too much). A symmetrical argument, exactly as strong as that one, could be made for extremely heavy taxation on all income above the median, since it is relative rather than absolute income that affects people's happiness (once they are out of poverty). It is our opinion that moving back toward Eisenhower-era rates of taxation on the rich would be much more useful to society than reducing jury awards; at the very least, it would increase *our* self-reported happiness.

¹⁶ See, e.g., John Harsanyi, *A Theory of Prudential Values and a Rule Utilitarian Theory of Morality*, 12 *SOC. CHOICE & WELFARE* 319 (1995).

V. CONCLUSION: GOING ALL THE WAY

We agree with many of Sunstein's conclusions. Welfare, not wealth maximization, is the important thing. WTP is not a good measure of welfare if (as usual) information is inadequate and some people are poor. Beyond satisfying basic needs, wealth also is not a good measure of welfare. Substantial wealth redistribution is justified even if it is inefficient in a narrow sense. People often make choices that do not improve their own welfare.

By this point in the story, Paretoville should be no more than a tiny speck in the rearview mirror. But Sunstein seems to be having a hard time saying goodbye. If he leaves Paretoville, and WTP along with it, then what of the cost-benefit analysis, which he has so fervently promoted and which depends so crucially on WTP? And what of the economic theories from which his work is launched? Our simple advice: let them go. There are better destinations ahead. The large importance and generous vision of Sunstein's article lie in his embrace of the egalitarian assumption of the comparability and comparable worth of all human beings. This assumption shatters the old economic theories and drives Sunstein toward a break with the past, perhaps a more fundamental one than he realizes.