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The Disappearing Benefits of Energy Efficiency

BY SOFIE E. MILLER

In the past decade, federal agencies have greatly increased the number of regulations establishing energy efficiency standards for household and commercial appliances. In 2014 alone, federal regulations setting energy efficiency standards accounted for an estimated \$154 billion in total regulatory benefits.

Because these regulations target common household appliances, they affect nearly all Americans. For example, the U.S. Department of Energy (DOE) recently finalized energy efficiency regulations for dishwashers, microwaves, clothes washers, furnaces, and air conditioners—appliances that most households rely on for everyday tasks. Each of these rules increases the price of appliances in return for reducing long-term energy usage and energy bills.

Because of the scope of these rules, it is important to examine the rationale that regulators use to justify them. *Prima facie*, it seems that consumers wouldn't need government protection from their own purchase choices. As a result, federal regulators have increasingly cited behavioral economics and "consumer irrationality" to justify standards that limit the amount of electricity and water that appliances can use. Because they claim such large regulatory benefits—and because they affect all households—these rules and their justifications merit a closer look.

Whose benefits? / Between 2007 and 2014, energy efficiency standards promulgated by the DOE accounted for an estimated \$26.6 billion in annual benefits. My recent working paper, published by the George Washington University Regulatory Studies Center, attempts to get to the bottom of the question: whose benefits are these, anyway?

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Tallying the benefits of all energy efficiency rules finalized in these years finds that the DOE relies on two types of regulatory benefits to justify its regulations: private benefits to consumers from reduced energy expenditures, and the international benefit of reducing carbon dioxide emissions.

Of the \$26.6 billion in annual benefits that the DOE expects from its rules, some \$23.4 billion (88 percent) are private benefits, and the remaining \$3.2 billion are public benefits to the environment from reduced emissions. The reported benefits of these rules greatly outweigh the estimated costs: based on the DOE's analysis, consumers gain \$18.8 billion annually on

net from efficiency standards. Given that the rules are ostensibly motivated by environmental goals, the reliance on private benefits—rather than public benefits—may come as a surprise.

Without the \$23.4 billion in private benefits, the costs of these standards outweigh the public benefits by \$4.6 billion annually. That suggests the rules are not "made necessary by compelling public need" as directed by Executive Order 12866, issued by President Bill Clinton. Instead, the DOE justifies them with estimated private cost savings that, in most cases, consumers and businesses could achieve without government intervention.

The pervasiveness of these private benefits suggests that none of the rules could be justified based on their environmental benefits alone. But what could be the goal of these rules, if not to better the environment?

Vanishing benefits / These analyses are highly sensitive to the scope and prevalence of private benefits—and, to a lesser extent, international benefits—that the DOE chooses to include. The private benefits, in turn, are driven by the DOE's assumptions about future energy prices, appliance characteristics, and discount



rates. A different set of assumptions that relies on consumers' revealed preferences indicates that the rules result in large net costs for consumers and businesses.

Standard economic analysis of regulations relies on the concept of consumer sovereignty and traditionally treats market participants as if they are rational actors. This allows regulators to measure potential consumer and producer surplus and infer the social value of regulatory policies. However, the private benefits the DOE relies on are a departure from the norms that have traditionally governed cost-benefit analysis.

In many cases, consumers already had the option to purchase more efficient appliances prior to regulation, indicating that a lack of energy-efficient appliances available in the market is not the impetus for these standards. Because more efficient appliances typically have higher prices than their less efficient competitors, some consumers choose not to purchase the more expensive goods. Regulators draw on the behavioral economics literature to argue that those consumers fail to purchase high-efficiency appliances because of inadequate information-processing capability. The DOE's reasoning is that consumers pass up these products because they're not capable of weighing the higher upfront price against the long-term energy savings.

This line of reasoning overlooks the possibility that consumers may have legitimate preferences for less-efficient appliances based on household characteristics or other observable product qualities (such as size, durability, reliability, or noise level). Also, the assumptions underpinning the DOE's analyses may not be accurate; for instance, some consumers may have high discount rates, making future energy savings less important than immediate purchase savings. By regulating away the option for consumers to purchase less-efficient appliances, the DOE claims to be improving consumers' choice structure by removing choices. These rules aren't technology-forcing, they're consumer-forcing.

Instead of taking consumers' actual

purchases as indications of legitimate preferences, the DOE argues that they reveal behavioral biases that could be resolved through regulation. However, the fact that consumers choose not to purchase efficient appliances indicates only that they do not value these attributes as much as the DOE does. As a result, these rules impose huge net costs on consumers, rather than benefits.

Looking forward / The pace of energy efficiency rules has accelerated over the past five years, and that pace now appears to be increasing further. The fall 2015 *Unified Agenda*, which forecasts agency regulatory activity for the following year, lists 18 proposed rules and 18 final rules establishing energy efficiency standards for appliances. If the past decade is any indication, the

DOE will continue to rely—heavily—on highly questionable private benefits estimates to justify reducing consumer choice. Whether those benefits will materialize for consumers remains to be seen. R

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What Is a Market Economy?

BY PIERRE LEMIEUX

The U.S. government is said to have warned the European Union against granting “market economy status” (MES) to China. This status would impede EU member states’ ability to impose antidumping tariffs on imported Chinese goods. It would also put pressure on other members of the World Trade Organization (WTO), including the United States, to grant MES to China.

Whatever decision the EU makes, debate on China and MES will continue around the globe. Many experts think that in December 2016, 15 years after China joined the WTO, the country must be granted MES by all members; other experts disagree.

Is China a market economy? / MES is WTO legalese. The content and conditions of MES are defined by each member country’s domestic legislation—or by the EU government in the case of EU countries. In the EU as in the United States, the criteria for granting MES are vague. In

American law, a nonmarket economy is defined in a way that leaves much room for interpretation; characteristics to be considered include “such other factors as the administering authority considers appropriate.”

We can consider market status from an economic, as opposed to a political, point of view: is China a market economy? On first glance, it seems it could only be labeled as such using an elastic or wishful definition of market economy. But then, any currently recognized “market economy” is a mix of economic freedom and government direction. The recognition of a country as a market economy remains a matter of degree over many dimensions. So it is difficult to determine whether one country fits in the category or not.

If we use the major indices of economic

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freedom, which rely on different indicators to calculate a score for each country, we find that China ranks quite far down the list. The Fraser Institute's *Economic Freedom of the World: 2015 Annual Report* has China in the lower part of the third quartile, which means that nearly three-fourths of the 157 ranked countries enjoy more economic freedom. Similarly, the Heritage Foundation's *2015 Index of Economic Freedom* ranks China near the bottom of the fourth quintile, whose members are considered to have "mostly unfree" economies.

In the near past, China did show some promise of becoming more of a market economy, as Ronald Coase and Ning Wang argued in their 2013 book *How China Became Capitalist* (Palgrave Macmillan; reviewed in the Winter 2011–2012 issue). But recent developments have not been encouraging. State banks and state enterprises remain big and incestuous players in a highly regulated economy. Censorship is on the rise. A welcome crackdown on corruption may transform into an excuse to bully businessmen. Crony capitalism still characterizes most of the Chinese economy.

Yet, the U.S. government's opposition to MES for China is motivated largely by protectionism, not concern about economic liberty. Like many national governments in Europe, the U.S. government is responding to demands from domestic business and union lobbies that fear competition from Chinese producers. (See "Protectionism by Any Other Name," Fall 2013.) Trade disputes often are exercises in crony capitalism, the cronyism being a matter of degree. Protectionism is further fueled by politicians' populist appeals, which have been especially abundant this election year.

What about the United States? / Since market economy status is largely a matter of degree, we may ask just how much the United States merits MES.

Returning to the indices, the Fraser Institute's ranking is based on five general factors that decompose into 42 distinct indicators. The five areas, which are given equal weights, are: size of government, legal system and property rights, sound

money, freedom to trade internationally, and regulation of credit markets, labor markets, and general business. In the free-trade category, America ranks 74th among the 157 countries—better than China's 109th, but hardly freedom's paradise.

According to Fraser, American economic freedom has been declining since 2000. On average, so have other OECD countries' scores, but the United States has dropped at a three-times-faster rate. The American retreat from economic freedom is due mainly to less freedom to trade internationally, more regulation, and less protection of property rights. If we consider its total index score from 1970 to 2000, the United States generally ranked as the most economically free country after Hong Kong and Singapore. It has now fallen to the 16th spot.

America occupies 12th place on the Heritage index, after such countries as New Zealand and Switzerland, but also

Canada and Denmark. The 76.2 score (on a possible maximum of 100) that produces this ranking pulls the country down from the "free" first quintile to the "mostly free" second quintile. The United States dropped out of the "free" quintile in 2010; it is a market economy only to a certain degree.

Another interesting observation: over the three decades in which we have data from China in the Fraser index, its economic freedom has increased by 67.1 percent. Over that same time, the United States has fallen by 2.4 percent.

Whether to grant MES to China is a political issue tainted by protectionist interests. To its credit, the European Union seems to be trying to pull away from such protectionism, but it is mainly because European politicians long for Chinese foreign investment. As for America, it used to be the beacon of liberty, but its light is dimming. R

Could PAYGO End the Prohibition on Paying Organ Donors?

◆ BY IKE BRANNON AND SAM BATKINS

What is the cost of self-righteous indignation? In the case of indignant opposition to compensating transplant organ donors, we can actually ascribe a number to it: a cool \$125 billion over the next decade for the federal government alone, according to a new study recently published in the *American Journal of Transplantation* (*AJT*). That staggering figure is just a fraction of the \$40 billion the federal and state governments spend each year providing free kidney dialysis for people suffering from renal failure, a sum that equates to nearly \$100,000 per dialysis patient per year.

But what if we paid organ donors, thereby boosting the supply of transplant organs? The authors of the *AJT* study

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estimate that if we were to pay kidney donors enough to eliminate the current organ shortage, it would generate \$46 billion per year in net societal benefits via longevity gains and a higher quality of life for transplant recipients. It would also save government roughly \$12 billion a year. Beyond saving money, compensating donors would also save lives: roughly 7,000 people die each year waiting for a kidney, liver, or heart to become available for transplant, and an equal number perish without being considered for a trans-



the health of people suffering from chronic illnesses. The ravages of diabetes that would have taken a life 30 years ago have been turned into chronic conditions that people can manage successfully for an extended period of time.

But while the demand for kidneys has exploded, the supply has not. And there is no reason to think that it ever will, given that there are no incentives in place to encourage people with two healthy organs to go through the pain, hassle, and slight increase in risk to their own health from a non-minor operation and life with one kidney. (For perspective, the death rate for a person donating a kidney

plant list because of the improbability that an organ could be found in time to save them.

While a few thousand preventable deaths may not be enough impetus for the government to relax the prohibition on paying organ donors, Congress's Pay-As-You-Go spending constraint offers a more tangible incentive to abolish this lethal ban. Under the current budget rules, any savings generated from a change in the law could be used to cut taxes or boost spending elsewhere. Given the dearth of usable "pay-fors" these days and the propensity of Congress to do favors for its constituencies, it has every reason in the world to enact such a bill.

Supply and demand/ The genesis of today's flawed transplant organ policy emanates from two pieces of legislation, the National Organ Transplant Act of 1984 (NOTA) and the Organ Donation and Recovery Act of 2004.

NOTA established the Organ Procurement Transplantation Network, a national system for matching organs and individ-

uals in need. Paradoxically, NOTA did nothing to drive down transplant waiting lists—in fact, the length and wait time has grown enormously since its passage. In 1988 about 16,000 individuals were awaiting an organ for transplant, a figure that jumped to 44,000 by 1995, and today exceeds 122,000, which amounts to a 700 percent increase in 24 years. There are currently a little over 100,000 patients seeking kidneys alone, a number roughly equal to the population of Peoria, Ill. That number excludes people who need a kidney but who aren't put on the list because they aren't expected to survive long enough for one to become available to them under current rules. The National Kidney Foundation estimates that 500,000 Americans are on dialysis.

The explosion in the number of people awaiting a kidney transplant owes largely to two factors: First, higher obesity rates have contributed to a large increase in the incidence of type 2 diabetes, which greatly increases the incidence of renal failure. Second, advances in medicine have improved

is about 0.2 percent, or one out of every 5,000 donors.) The long waiting lists lead to a predictable outcome: a significant proportion of these people do not survive the wait. Approximately 5,000 to 10,000 people die each year while waiting for a kidney transplant.

NOTA explicitly prohibits the buying or selling of organs "for valuable consideration for use in human transplantation," stating that the intent of the legislation was to make the buying and selling of human organs unlawful. (The law does allow for the recipient to reimburse the donor for various expenses, such as lodging, lost wages, direct and ancillary medical bills, and transportation.) The penalties for breaking this law are stiff: violators are subject to a \$50,000 fine and up to five years in prison.

The enormous worldwide shortfall in organs has been slightly ameliorated within the last decade, thanks to two innovations. The first has been the advent of the "opt-in" default on driver's licenses in several countries, although it has yet to be adopted anywhere in the United States.

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Instead of someone needing to affirmatively check a box to become an organ donor, the presumption in these countries is that the person agrees to be an organ donor unless he or she actively opts out of participating. This has increased participation rates in these countries, but the gains have been minimal, partly because of stubborn cultural stigmas against organ donors as well as the fact that most countries with this default still require permission from the next of kin.

The other innovation has been the matched kidney exchange program, pioneered by Nobel economics laureate Alvin Roth. This consists of a sophisticated computer algorithm whereby someone who wants to donate a kidney for a friend or relative, but is not a tissue match for the intended recipient, is instead paired to donate to another person who also has someone willing to donate on his or her behalf. By connecting a network of such donors, it becomes possible to create a match of numerous donors and recipients in a virtual domino chain. It has been estimated that this system has resulted in 2,000 kidney transplants that would not have occurred otherwise.

People who oppose allowing organ donors to receive compensation like to suggest that improvements in such schemes hold the potential to alleviate the chronic shortage. However, neither has come remotely close to eliminating the mismatch between kidney donors and those in need of a transplant. Suggestions that perfecting these systems will prove sufficient amounts to little more than wishful thinking.

Political economy/ The main criticism of donor compensation is that poor individuals, desperate for money, will sell their organs to wealthy patients. However, that doesn't come close to describing the situation at hand. A study published in the *AJT* late last year points out that the recipients of donated kidneys were typically at the lower end of the eco-

omic ladder. In general, the poor (and African-Americans) tend to be overrepresented on kidney waiting lists and stand to benefit the most from compensating donors. It is not far-fetched at all to assert that such a policy would, in fact, reduce income inequality. For taxpayers and society, the billions of dollars of savings—as well as billions of dollars of benefits, both tangible and intangible, that accrue to the recipients of new organs as well

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as the federal government—deserve to be presented in opposition to the moral hand-wringing surrounding the compensation of organ donors.

Most debates on the issue ultimately fail to go beyond the same narrow ethical discussions. We eschew this debate and instead simply offer the observation—but dressed with data—that the federal government can reap significant cost savings from compensating organ donors.

To overcome the poor donor/rich recipient concern, the *AJT* compensation study proposes that the federal government—and not the organ recipients—pay potential donors \$45,000 per kidney for living donors or \$10,000 for deceased donors. The authors estimate those amounts are high enough to allow supply to meet demand.

The study uses data from the U.S. Renal Data System and the Scientific Registry of Transplant Recipients. It values a quality-adjusted life year (QALY) at \$200,000, which is the consensus estimate of the implicit value that the average person assigns to a year of life as exhibited in various decisions people make in the everyday world. The authors find that the substantial gains they ascribe to the government compensating organ donors holds even with a QALY valued at \$100,000 or up to \$300,000.

The estimated benefits from this proposal are profound. For instance, a typical patient on dialysis can expect to live 12.3 years, but a kidney transplant adds an additional seven years to his or her lifespan on average, which amounts to a lifetime welfare gain of nearly \$1 million per kidney recipient.

The actual cost savings from removing someone from dialysis are also large. The cost of a typical transplant is \$145,000, a figure that varies quite a bit depending on the region, hospital, and doctor involved. There are also medical costs following transplants—most notably the provision of costly anti-rejection drugs—that can cost tens of thousands of dollars a year. The cumulative costs resulting from a kidney transplant can approach \$500,000—a sizeable amount, but one that pales in comparison to the \$100,000 per person per year that it costs the government to provide dialysis.

If we add up the savings just to the government from taking tens of thousands of people off the rolls of kidney donors, the result is a staggering cost savings: the authors estimate that the net gains to the federal government from compensating kidney donors would be \$120 billion over the next 10 years.

Legal barriers/ Whenever someone argues that a policy change would generate enormous gains to society—and can quantify those gains in a way that's essentially impossible to dispute—it makes sense to ask why we haven't already adopted it, and whether there are compelling reasons to keep the status quo.

From a political economy perspective, it's perfectly sensible that we don't compensate organ donors: the people who stand to gain the most from this idea—people on dialysis—are predominantly low-income individuals who lack the wherewithal and energy to organize effectively. They don't have the resources to mount an effective campaign in Congress and no one stands to profit from a change.

However, the \$40 billion per annum that the government pays each year to dialysis companies has begotten several very large,

profitable companies that could go bankrupt if we were to compensate donors. It will always be easier to organize a small number of well-endowed entities who stand to lose significantly than a disparate group of poor people who stand to gain from such a change and may not even be aware of it, even though their potential gains dwarf the losses to dialysis companies.

Sometimes Congress must do more than adjudicate rival disputes between vested interests and do what's right for taxpayers and society at large. In this case, however, the gigantic pot of money that the government would save from compensating organ donors should provide a powerful incentive for Congress to act. Lawmakers could use that money to satisfy constituencies elsewhere by reducing taxes or increasing spending on other budget items—something that's nearly impossible to do today because of the budget rules currently in place.

By spelling out a concrete compensation scheme that obviates fears of wealthy people gaming the system and also clearly illustrates the enormous government cost savings, the authors of the *AJT* study may have set in motion a radical change in how we deal with organ donor shortages in the United States. R

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Obama's Midnight

BY DANIEL R. PÉREZ

The end of President Obama's administration is likely to be accompanied by a rush of regulatory activity that could affect both the quality of these regulations and the amount of time it takes for the next president to start implementing his or her political priorities.

As presidential administrations wind down during their “lame duck” period, the executive's decrease in political influence in Congress has historically been accompanied by a significant increase in the amount of regulations published by executive regulatory agencies. This is particularly true for the final three months between Election Day and Inauguration Day.

This flurry of last-minute regulatory activity, identified as early as the final months of the Jimmy Carter administration, is known as the “midnight period.” Midnight rules are so named because they are the result of an executive fully exercising its power to influence policy through regulation in a rush to beat the “stroke of midnight” on Inauguration Day, which removes its political power—like Cinderella's magic running out as she leaves the ball.

Two important things to consider regarding President Obama's probable upcoming spike in regulatory output are the number of regulations likely to be issued during the administration's final months and the response of the incoming administration. In this article, I compare Obama's current regulatory output with his predecessors', under the theory that the difference may predict how Obama's midnight period will compare to those predecessors. I also describe the tools available to both the next president and Congress to respond to a last-minute surge in regulations.

Differences between presidents / The phenomenon of midnight rulemaking affects the amount of time and regulatory oversight these rules receive before

being published. This has direct implications for the quality of review that the Office of Information and Regulatory Affairs (OIRA) is able to provide. Additionally, this last-minute rush to publish can reduce the time allowed for public comment during rulemaking and the time that regulatory agencies have to seriously consider those comments and use the public's input to improve the quality of their regulatory analysis.

In order to get a better sense of what the next midnight period might mean for the quality of regulatory oversight, it is important to compare President Obama's current regulatory output to his predecessors'. Since Presidents Bill Clinton and George W. Bush both served for eight years, I can compare the volume of regulations published during their tenures in office and overlay them with President Obama's pace through January of 2016. See Figure 1.

I focus my comparison on economically significant rules: those defined in Executive Order 12866 as likely to have “an annual effect on the economy of \$100 million or more.” These rules are important not only because of their economic effect, but also because studies have shown that every additional economically significant rule submitted to OIRA during the midnight period decreases the mean review time of all regulations by almost a full day.

In addition to comparing the cumulative number of economically significant regulations published each month, I examine the last quarter of every president's time in office, which I define here as the midnight quarter, and compare them to non-midnight quarters to illustrate the level of increase in regulatory output across administrations. See Figure 2.

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Economically significant regulations / I tracked the cumulative number of economically significant rules published by the previous two administrations and overlaid the data with President Obama's regulatory output through January 2016. Note that because of a lag in recording publication dates, this may understate the number of published rules in recent months. I began counting rules as of the February after Inauguration Day for each president, because any regulations published in the *Federal Register* during the last week of January, immediately after Inauguration, are likely to be the midnight regulations from prior administrations.

Over their eight-year terms, Clinton issued a total of 361 economically significant rules and Bush issued 358. As of the end of January 2016, Obama had 393, with 12 months remaining in his administration.

The fall 2015 *Unified Agenda* includes 95 economically significant rules currently slated for publication before the end of Obama's term. If these final rules are all issued on schedule, his eight-year total would be 462. The *Unified Agenda* serves as a good indicator for upcoming regulatory output, but the actual number of published rules could be lower if agencies don't finish the rules they are working on— or higher if something unexpected arises.

Midnight rules / To illustrate the increase in rules issued during the midnight quarter, it is useful to compare regulatory activity in this three-month window with comparable "final quarters" (November, December, and January) during non-midnight periods. President Clinton averaged 8.5 economically significant rules in each of his non-midnight final quarters, and issued a total of 38 economically significant rules during his midnight quarter—4.5 times the average for the other final quarters. President Bush averaged 11.4 economically significant rules per quarter for non-midnight final quarters, and issued 35 economically significant rules during his midnight quarter—roughly three times the average for other final quarters. President Obama

FIGURE 1
CUMULATIVE NUMBER OF ECONOMICALLY SIGNIFICANT REGULATIONS PUBLISHED AT EQUIVALENT PERIODS IN OFFICE

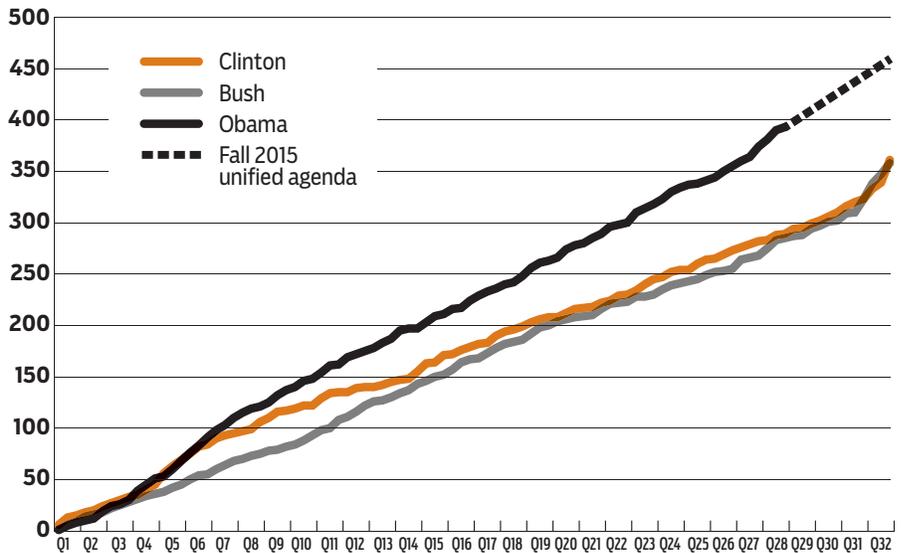
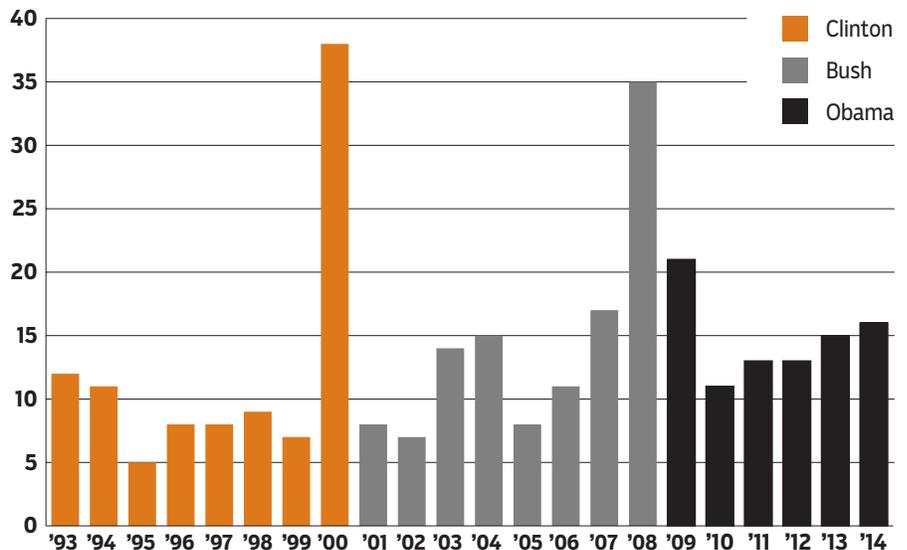


FIGURE 2
ECONOMICALLY SIGNIFICANT RULES PUBLISHED BY PRESIDENTIAL YEAR
Final Quarters (November, December, January)



Note: President Clinton's Midnight quarter is shown in 2000; President Bush's Midnight quarter is shown in 2008

has not reached his midnight period, but he currently averages around 15 economically significant rules per quarter for non-midnight final quarters.

Response of the incoming executive / Ever since Ronald Reagan entered the Oval Office after Carter's midnight quarter

—which had a regulatory increase of roughly 40 percent compared to Carter's previous final quarters in office—presidents have taken measures to halt the prior administration's midnight regulations and evaluate them. This begins the process of balancing the tradeoffs between looking back, which requires

expending political capital to overturn those regulations most out of sync with the new administration's policy goals, and looking ahead, which allows the new administration to begin implementing its regulatory priorities.

Although the responses differ slightly among incoming administrations, the actions taken usually involve a memorandum issued by the newly elected president's chief of staff to the heads of regulatory agencies instructing them to put an immediate freeze on publishing any new rules in the *Federal Register*, withdraw rules currently under OIRA review, and extend by 60 days the effective date of any rules already published but not yet in effect.

Response by Congress / In addition to these executive actions, Congress also has the ability to exercise its legislative powers under the Congressional Review Act (CRA) to rescind federal regulations published during the last 60 session days of the previous legislative session. This would include any of the aforementioned economically significant rules listed in the fall 2015 *Unified Agenda*.

Interestingly, although thousands of rules have been submitted to Congress for disapproval under the CRA since it was enacted in 1996, only one rule has successfully been rescinded: a Clinton administration midnight Occupational Safety and Health Administration regulation involving workplace ergonomics standards. During the non-midnight periods, lack of congressional disapproval can be credited largely to presidents' ability to veto the disapproval legislation, requiring a two-thirds congressional majority to override. But when a new Congress convenes after a midnight period, it may face a very different dynamic: a congressional resolution disapproving a rule issued at the end of one president's term is less likely to be vetoed by the incoming president. The possible absence of a presidential veto means that Congress would only be required to muster a simple majority in each house in order to pass a joint resolution of disapproval.

Conclusion / President Obama's regulatory output to date has already surpassed both of his predecessors, and it is understandable that observers are carefully considering the possible effects of a surge in rules published within this administration's midnight period. A significant increase in regulatory output is likely to reduce the amount of time available for agencies to seriously consider public comment, affect the quality of oversight that OIRA is able to provide, and also add

considerable political constraints on the incoming administration. R

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Are Cigarettes a Giffen Good for Poor, Expectant Women?

◆ BY IKE BRANNON

Since the 19th century, economists have been speculating about the existence of a "Giffen good"—a good with an upward-sloping demand curve, meaning that demand for the good increases as its price increases (all else equal). At first blush, such a good seems impossible.

A normal demand curve slopes downward for two reasons: First and most obvious, as the price of the good increases, consumers will substitute other products in its place—what is known as the "substitution effect." That is, if the price of a hamburger goes up, consumers will shift to eating more pizza and chicken sandwiches.

A second reason is that if the price of a commonly purchased good increases, consumers are left with less real income. Thus, consumers simply won't be able to buy the same amount of goods and services—including the costlier good—that they did before. This latter phenomenon is called the "income effect," because consumers' purchasing behavior changes depending on their real income.

Yet, some goods clearly do have a negative income elasticity, meaning that when a person's income increases, he buys *less* of the good. In essence, in these cases the income effect works against the substitu-

tion effect: suddenly wealthier consumers purchase less Ramen noodles and fast food even though they can now afford to buy more of those goods. Instead, those consumers buy more steak and more meals at upscale restaurants. Because of this characteristic, economists refer to goods like Ramen and fast food as "inferior goods," and steak and upscale restaurants as "superior goods." Notice that if a person's real income were to fall, Ramen and fast food consumption should increase.

Given the existence of inferior goods, it's possible to imagine a Giffen good. A good could be so inferior that, if the consumer's income were to fall at a time when the inferior good's price is rising, the income effect on the inferior good could fully overcome its substitution effect. Voilà: consumption of the inferior good increases despite its rising price, and the good is a Giffen good.

Despite the theory, it's difficult to identify a real-world case of a Giffen good. The most plausible candidate in history seems to be potatoes in Ireland during

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the 1845–1849 Great Famine, when consumption seemed to not lose pace despite soaring prices. But even in that extreme case, scholars are uncertain if potatoes actually passed the positive-slope threshold of a Giffen good.

However, some new evidence suggests that cigarettes may approach this dubious distinction for an important group of society: low-income pregnant women. It's a possibility that suggests the government should hesitate before it considers future "sin" taxes.

Substituting away from health / The data come from a new paper on cigarette taxes published in the journal *Pediatrics*. The paper's top-line finding is the estimate that a recent \$1 per pack federal cigarette tax increase reduced smoking in expectant mothers, which in turn reduced infant mortality by 1 per 1,000 live births. Despite that effect, the authors did not recommend further tax increases, worrying that some expectant mothers may simply be unable to stop smoking. If their taxes were increased further, these women may be forced to reduce their consumption of healthy goods and services to be able to afford (and perhaps even augment) their smoking habit. As a result, further reductions in infant mortality from higher taxes may not be forthcoming—in fact, some of the gains from the last tax increase could potentially be undone.

The authors' show of discretion when it comes to their study's implications is rare and welcome. I attribute their wisdom to their being doctors and not policymakers, and thus they are familiar with unwelcome side effects. When it comes to tax policy as well as regulatory policy, the notion of diminishing returns often gets ignored by government.

For instance, a decade ago, government considered lowering the maximum allowable concentration of arsenic in drinking water from 50 parts per billion to 30. (See "Spe-

cial Report: The Arsenic Controversy," Fall 2001.) Evidence that the proposed standard would have yielded significant health benefits was thin and cost estimates for compliance with the proposed standard were enormous. That led to the worry that the proposed standard would, on net, harm public health because money devoted to arsenic reduction would be reallocated from other uses—including other initiatives to improve public health and safety.

Likewise, higher cigarette taxes can come with a whole host of unwelcome outcomes. Besides a potentially deleterious effect on pregnant smokers and their children, we might also expect a greater demand for black-market untaxed cigarettes—something that inevitably occurs with each cigarette tax increase—or smokers substituting toward other substances that can be just as harmful to one's health as cigarettes, if not more so. For instance, while I welcome the slowly spreading legalization of marijuana, there's no real health difference between smoking a tobacco cigarette and a

marijuana cigarette. The tax on both should be, apropos Pigou, high enough to correct any external costs of consumption that are borne by society, but no higher.

Giving up cigarettes is easier said than done, of course. Nicotine is an addictive substance and its effects on the nervous system differ greatly from person to person. Some people find kicking the habit to be extremely difficult, no matter how strong their resolve to avoid tobacco use, while others find it easier to quit. What's more, some low-income people may not have knowledge or ready access to tobacco substitutes or may not appreciate the potential costs of continuing to smoke during a pregnancy.

In other words, the decision to smoke during a pregnancy can be complicated, and a prohibitive tax alone is not going to eliminate it. In a similar vein, a recent National Bureau of Economic Research paper found a virtual nonresponse to higher cigarette taxes in smoking among teenagers following the most recent tax increases at the state level. (See "In Review: Working Papers," Winter 2015–2016.)

Policymakers tend to reflexively treat a tax on goods with high social costs as an easy and uncontroversial method to improve societal outcomes, but the world is more complicated than that. At some point the gains from additional cigarette tax increases diminish and the tax becomes little more than a way for government to extract money from the low-income Americans who now constitute the majority of smokers in the United States. Cigarette taxes may be approaching that stage. R

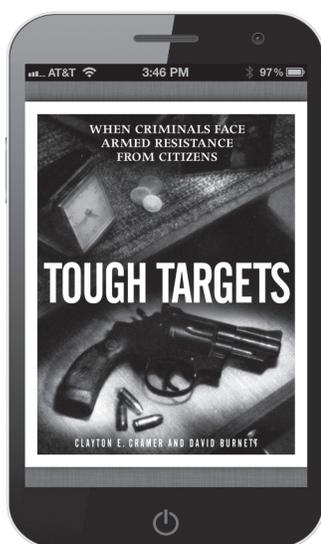
READINGS

- "Cigarette Tax and Infant Mortality," by Stephen W. Patrick, Kenneth E. Warner, Elisabeth Pordes, and Matthew M. Davis. *Pediatrics*, Vol. 137, No. 1 (January 2016).
- "Cigarette Taxes and Youth Smoking: Updated Estimates using YRBS Data," by Benjamin Hanlin, Joseph Sabla, and Joseph Rees. National Bureau of Economic Research Working Paper #21331, June 2015.



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