HEALTH & MEDICINE

THE WAR ON CONSUMER SURPLUS

To fight tobacco use, "prominent economists" have turned welfare economics on its head.

BY PIERRE LEMIEUX

At least 77 national governments now impose graphic health warnings—images of diseased lungs, cancerous mouths, and such—on cigarette packs and other tobacco packaging. The United States is the major holdout, but that may be changing. In 2012, a federal district court struck down a 2011 regulation by the U.S. Food and Drug Administration that would have mandated graphic health warnings. Anti-tobacco groups are now suing the FDA to force it to try graphic warnings again.

The ultimate goal of anti-smoking groups is to impose "plain packaging": mandating that tobacco product packaging show only a brand name in standard fonts along with health warnings against a drab background. They have already achieved this in Australia. In three European countries—the United Kingdom, France, and Ireland—a similar obligation is being phased in. Several other national governments (including the Canadian government) are considering the measure. Plain packaging is the new frontier of tobacco control.

COST-BENEFIT ANALYSIS

In Australia, plain packaging was implemented on December 1, 2012. At the beginning of 2016, the Australian government published a series of evaluation reports purporting to show that the experience has been a success, reducing the smoking prevalence by 0.55 percentage points to 17.21%. The reports included a cost-benefit analysis of the policy, which concluded that the benefits of plain packaging exceed the costs. The FDA also produced a Regulatory Impact Analysis to justify its 2011 regulation. In order to reach their conclusions, both analyses abandoned standard methodology by tampering with what economists call the "consumer surplus."

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Cost-benefit analysis is the practical implementation of welfare economics, a field of economic theory. It provides a method for evaluating government policies, programs, and projects according to their contribution to "social welfare"—that is, to the utility or welfare of all individuals in society. Subtracting the social costs of the policy from its social benefits gives the change in social welfare.

Welfare economics and cost-benefit analysis stand on the normative side of economics. What *should* be done is the question. Instead of importing an external notion of what is moral or good, economists traditionally have used individual preferences as the ultimate criterion. Individual preferences constitute the foundation of the cost-benefit methodology: all costs and benefits are defined from the point of view of the subjective preferences of the individuals involved.

Social costs are the total cost of real resources (labor and capital) used in the project or policy under consideration. They are made of private (or internalized) costs and external costs. Internalized costs are borne by the willing parties in a transaction and those parties have ample incentive to consider the costs when deciding whether to trade. Likewise, the parties naturally consider the internalized benefits. External costs—also called "negative externalities"—are real costs that are shifted to unwilling third parties; a classic example is pollution. Similarly and symmetrically, social benefits are the sum of private benefits to individuals and of any external benefits generated for third parties.

The main source of private benefits is "consumer surplus," defined as the difference between what individuals would be willing to pay for a good or service (or activity) and the price they effectively pay. Technically, it is the area under the demand curve less consumer expenditures. It is the net benefit that consumers get. As welfare economist and cost-benefit expert E.J. Mishan wrote, "The consumer's surplus is the most crucial concept in the measurement of social benefits in any social cost-benefit calculation." The normative significance of consumer surplus comes from it being entirely based on individual preferences—that is,

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on each individual evaluating what is good or bad for himself.

An important note: we are, of course, talking about adults' preferences. By definition, children need compulsory tutors; adults don't. This is how children and adults are legally distinguished in a free society. Only in a philosophy at the polar opposite of standard normative economics could the state claim parenthood over adult citizens.

According to welfare economics, government intervention is required if and only if externalities are present; otherwise, free markets automatically maximize social welfare. When government considers intervening, cost-benefit analysis tries to determine if the intervention will result in more (increased) benefits than (increased) costs.

In the case of tobacco control policy, standard cost-benefit analysis would equate the social cost of the policy to the real resource cost of implementation (enforcement and private compliance costs), plus the loss in the smokers' consumer surplus. The benefits of the policy would include any possible increase in nonsmokers' consumer surplus—for example, through reduction in involuntary absorption of secondhand smoke (assuming there is some measurable and unavoidable harm there).

The health care costs of smoking would be a matter for each smoker to consider when he brings his demand for tobacco to the market. The adult smoker's health and productivity belong to him, so his decision to smoke involves only private costs, which (in his evaluation) are lower than the subjective benefits he obtains from smoking. Note that subsidized health care expenditures are not a real cost but merely a transfer—which, in the case of smoking, goes from smokers to nonsmokers as the former die younger and collect less in public pensions.

BEYOND SOCIAL WELFARE

For decades, the public health literature ignored the economic method and considered smoking as an involuntary disease that had only costs and no benefits. Contrary to welfare economics and cost-benefit analysis, public health theory and advocacy were based on the preferences of those doing the research and advocacy. In its public policy pronouncements, public health research was all but scientific. This is not surprising because contemporary public health is more a political movement than a scientific field of study. (See "The Dangers of Public Health," Fall 2015.)

Starting in the 1980s, several economists showed that the public health research on smoking costs and benefits was methodologically flawed. Public health researchers did not factor in the smokers' subjective benefits. They confused private and external costs, assuming that a smoker's productivity belongs to "society." They confused real costs and mere transfers. They committed many other elementary errors. In a 1989 *British Journal of Addiction* article, economists A. Markandya and D.W. Pearce wrote: "The overriding conclusion on the empirical literature must be that the various estimates produced are generally without foundation in any adequate theory of social cost." Many other economists showed that, with a proper accounting of costs, there was no net external cost of smoking. The demonstration was devastating—or should have been.

In the 1990s, the World Bank came to the rescue of the anti-smoking movement. This organization gathered a group of economists who started turning cost-benefit analysis on its head. They claimed that smokers did not have the consumer surplus they thought they had because they lacked complete information about the health consequences of smoking and because they were addicted to tobacco. Their argument was patchy, but one could argue that it was a big improvement over the methodological desert of public health advocacy. (See "The World Bank's Tobacco Economics," Fall 2001.)

Yet, the World Bank economists were prudent. "Smokers clearly receive benefits from smoking," admitted a quartet of authors that included well-known economist Frank Chaloupka in a 2000 book sponsored by the World Bank and the World Health Organization, "otherwise they would not pay to do it." In the same vein, Kenneth Warner, a professor in the Department of Health Management and Policy at the University of Michigan's School of Public Health and another one of the World Bank's external economists, wrote that "tobacco produces utility for some member of society" and "this utility warrants recognition (and perhaps some respect) in planning optimal control policy."

NINE "PROMINENT ECONOMISTS"

This prudence was soon brushed aside. Once the trick of cropping consumer surplus was discovered, dirigiste economists and public health activists rapidly became addicted to this methodological nicotine. They were assisted by the elitism of the developing field of behavioral economics, which tends to reject the normative value of individual preferences.

Today, revisionist economists and their new public-health fans openly claim that standard cost-benefit analysis does not apply to tobacco. Misinformed and addicted smokers cannot make rational choices and have virtually no consumer surplus, they claim. For instance, nine economists, presenting themselves as "a group of prominent economists," made this argument in a 2014 *Tobacco Control* article. They criticized the FDA for taking cost-benefit analysis too seriously when it had evaluated the social benefits and costs of the graphic warnings (before their mandate was struck down by a court).

The "prominent economists" rejected the "assumptions from traditional economic theory" and stated that "nearly all of the 'lost pleasure' from tobacco use, as represented by conventionally measured consumer surplus, should not be included as a cost in FDA analyses of the economic impact of its tobacco regulations." Is short, they wrote, "we find it inappropriate to measure the area under a demand curve to define welfare."

Tobacco Control is an interesting creature in itself. Despite all the bells and whistles of a peer-reviewed journal, it looks more like an activist organ of the anti-smoking movement. Kenneth Warner, one of the rare economists associated with *Tobacco Control* and the chairman of its editorial board, was one of the signatories of the article. Both Warner and Chaloupka exemplify the economists who have discarded consumer surplus when dealing with tobacco.

Before the 2014 *Tobacco Control* article, the FDA was not a standard-bearer for cost-benefit analysis or a shining-knight defender of consumer surplus. Its 2011 cost-benefit analysis—the one criticized in the nine economists' article—did acknowledge that "the concept of consumer surplus is a basic tool of welfare economics." This tool could not be rejected if a "full and objective analysis" was to be realized according to federal guidelines. But it did suggest cutting 50% of the smokers' consumer surplus, as opposed to the 75% advocated by the World Bank and the *Tobacco Control* article.

The manipulations of the FDA and the nine economists are rather complicated and messy. The Australian government's "cost-benefit analysis" made everything easier by simply rejecting consumer surplus altogether. Invoking the "prominent economists," a two-page blurb in the report concludes that "loss of consumer surplus is not an appropriate consideration with respect to tobacco control interventions" because smoking does not represent the smokers' "true preference."

This ad hoc modification to standard economic methodology violates the Australian government's own rules for cost-benefit analysis, which do not mention any possibility of even reducing consumer surplus. On the contrary, its *Handbook of Cost-Benefit Analysis* clearly states, "A core principle is that goods are worth what people are willing to pay for them." But when you absolutely want to prove something, even core principles shouldn't be impediments.

INCOMPETENT INDIVIDUALS?

There are many problems with these attacks on consumer surplus and cost-benefit analysis. It is not at all clear that addiction or misinformation is sufficient to negate smokers' consumer surplus.

Addicted consumers can still make decisions that maximize their utility. Gary Becker, the 1992 Nobel Economics Prize winner, showed how addiction can be a rational response to difficult life circumstances. Addicts are not happy but they are, according to their own evaluation, less unhappy than they otherwise would be. And we know that quitting smoking is not impossible. Two anti-smoking activists, Gerard Hastings and Crawford Moodie, admit it bluntly in a *Tobacco Control* article ("Death of a Salesman," April 2015):

> That [smokers] are amenable to change is beyond question: in Australia (as in many other markets) there are more ex-smokers than current smokers.

Assume that, as the nine "prominent economists" argue, close to half of smokers "were daily smokers before age 18" and were therefore addicted. It would remain true that the majority were *not* addicted before they were recognized as adults.

The second main reason invoked to negate consumer surplus in the case of smoking is the allegation that consumers lack sufficient information about the health consequences of smoking. The truth in this is far from obvious. According to research by Vanderbilt economist W. "Kip" Viscusi, consumers do not underestimate the risk of smoking but, on the contrary, they overestimate it compared to the U.S. government's own estimates. According to official estimates, smokers' lifetime death probability from lung cancer is 0.08, and 0.26 from all smoking-related diseases, while people on average put these risks at, respectively, 0.41 and 0.50.

Moreover, Public Choice analysis suggests that government officials and public health experts, who are often subsidized, have their own incentives to mislead and misinform citizens in order to increase their power and perks.

Besides addiction and misinformation, other justifications for negating consumer surplus relate to personal failings such as cognitive limitations, lack of self-control, and time inconsistency. Time inconsistency means that an individual discounts the far future at a higher rate than the near future, leading to regrets as the future approaches.

However, government officials—that is, politicians and bureaucrats—suffer from the same failings as ordinary individuals. Furthermore, politicians are supported by these very individuals who are assumed incapable of determining what is good for themselves. And the bureaucrats are hired, even if indirectly, by these same politicians.

Anti-smoking economists often summarize the reasons for government intervention in the catch-all of "market failures"—that is, externalities. The problem is that there are few if any real externalities in smoking. To save the argument, they conceive of addiction, imperfect information, and cognitive limitations as "internalities," a sort of internal externality, a punishing oxymoron that a smoker imposes upon himself. (See "Smoking 'Internalities,'" Winter 2002–2003.) Contrary to standard normative economics, this is a recipe for coercive elitism.

There is no reason to believe that politicians, bureaucrats, and academic philosopher-kings deciding in the place of individuals will better promote the latter's "real" interests. Political failures are at least as bad as—and generally more catastrophic than—market failures, even when the latter do exist. The extent of political failures in a democratic system was unwittingly illustrated by Jonathan Gruber, a Massachusetts Institute of Technology economist, consultant on the Affordable Care Act (ACA), and signatory of the nine economists' article. In a memorable video (easy to find on YouTube), Gruber declared that the ACA could not have passed without "the stupidity of the American voter" and a "lack of transparency," which provided ACA advocates "a huge political advantage."

SMOKING AND 1776

Governments and their economic advisers have looked very hard for reasons to ignore consumer surplus. Not surprisingly, they found them. If they looked as hard for reasons why anti-smoking policies decrease consumer surplus and utility in general, they might find them too, as well as some other problems. Here are some ideas for them.

Who knows what ugly, government-imposed packaging can do to people's sense of aesthetics over the long run? And who knows how sociability has been hurt by banishing smokers from private venues labeled "public places," and what are the long-term consequences of this lifestyle apartheid? (Note that it is illegal to open restaurants or bars "for smokers only and secondhand-smoke tolerants.")

But there is worse, even if that leads us to entertain ideas not much used since the Declaration of Independence and the Bill of Rights. Official meddling with consumer surplus increases the probability of tyranny and the mathematical expectation of its cost. If an individual's demand curve has no normative meaning, if an individual cannot determine what is good for himself, who will? Inconsistent majorities, political strongmen, faceless bureaucrats, or philosopher-kings in their academic ivory towers? How many other goods and services besides tobacco will be declared utility mirages with no real benefit? Where is the consumer surplus for sport utility vehicles, hunting, swimming pools, D.H. Lawrence books, wine, electric cars, or academic journals?

The cost of enforcing the war on consumer surplus may also be higher than envisioned by tobacco prohibitionists, regulators, and the nine "prominent economists." The killing of Eric Garner by New York City policemen while being arrested for selling contraband cigarettes should remind us that the war on smoking destroys lives too.

"Smoking literally rewires the brain," claim the "prominent economists," citing an article in a neuropsychiatric journal. But tyranny is certainly a worse addiction than smoking. Doesn't the habit of calling for authoritarian solutions to perceived problems also rewire the brain—including the brains of public health experts who spend their whole lives in milieus where they are constantly bombarded with such ideas? In *The State* (Liberty Fund, 1985, 1998), Anthony de Jasay writes of the possibility of long-term addiction to government.

What to conclude from this short review of the war on consumer surplus? Meddling with consumer surplus and redefining the methodology of cost-benefit analysis in order to fit the preferences of the analyst or his political masters is dangerous. It is a benefit, not a cost, that constitutional constraints would oppose such social engineering.

In the case of smoking and other activities, we can hope that the First Amendment will be more firmly recognized as giving protection to commercial speech just as it does to, say, the prominent economists' free speech in *Tobacco Control*. With some wishful thinking, we could also hope that the Fourth Amendment would protect the property rights of producers in their own packaging. *R*

READINGS

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