

## MPS2010 PAPER

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### Nannies and Busybodies

#### I. Of healthist nudges and shoves: the resurgent paternalistic threat to liberty.

If the right to swing your fist ends at my nose, then perhaps your right to take risks ends where I'm liable for the downside costs. Taxpayers have always been liable, through the public health system and public assistance, for some of the costs of individual risk taking. Simultaneous with increased public assumption of downside costs of individual risk-taking through expansions of public health sectors has been the proliferation of reports tabulating massive "social costs" of vices: drinking, smoking, gambling, drug use and obesity. If you're personally not offended by somebody else's drinking, you might change your mind if you think that "problem drinking" costs the country around a thousand dollars per capita. These measures of social cost persuade voters that policies countering the traditional vices aren't just a matter of nannyish paternalism but rather are essential protection for the taxpaying public against what Browning called "fiscal externalities".

While the perceived benefits of paternalistic policies have so increased, technological innovation in regulation has promised lower costs. Cass Sunstein and Richard Thaler's "Libertarian Paternalism is not an Oxymoron" is less than a decade old but has inspired policy action from the UK to Australia. The premise behind libertarian paternalism is reasonable: that the state often cannot help but to affect behaviour through its choice of default options; consequently, those options ought to be chosen such that the default works best for most people. A government seeking to achieve a paternalistic objective can do so at lower cost to overall liberty through these "nudge" options that allow people to opt out should they so wish.

The consequence of increased public demand for paternalistic regulation induced by perceived social costs of private behaviour, coupled with reductions in the costs of such regulations, pushes equilibrium policy outcomes towards more paternalism. If the cost studies underlying increased demand were right, and if nudge policies really came at little overall cost, this would very likely be optimal in a traditional efficiency sense. But neither of these premises holds. Instead, "social cost" studies vastly inflate costs relative to what economists would consider as external costs, or even as fiscal externalities. And nudges aren't always gentle.

I begin, below, by considering fiscal externalities. If social cost studies truly reflected the costs that individuals impose on taxpayers through various public support systems, would that prove sufficient basis, at least through the lens of economic efficiency, for regulations constraining individuals against taking risks that may impose such costs? I then contrast these idealized social cost studies with those whose figures have achieved most recent

prominence in the Antipodes before noting the real policy consequences of methodologically flawed social cost figures. After considering these demand-side shocks to preferences for paternalistic policies, I will turn to the supply side: “nudge” style regulations that promise paternalism at lower cost to liberty.

## II. Fiscal externalities and public subsidization of risk

Browning (1999) identifies fiscal externalities as being those that affect third parties through their budget constraint rather than their utility or production functions, following Buchanan and Stubblebine (1962), but that do not operate through the price mechanism. If I bid against you at an auction and drive up the price, I impose only a pecuniary externality on you of no efficiency consequence. If I win the auction and you’re required to pay the bill through the tax system, I’ve imposed a negative fiscal externality on you.

Browning argues fiscal externalities are best seen as pecuniary. As long as demand curves slope downwards, individuals will consume rather more of a subsidized good than would be optimal in a user-pays environment. But if the subsidy is in place because voters knew they would enjoy an altruistic externality through others’ consumption of the subsidized good, we cannot conclude that fiscal externalities are necessarily inefficient unless we know that the altruistic externality does not extend to that increase in consumption. Leaving aside for the moment the problems of deriving a revealed preference measure on policy from voting outcomes, if the subsidy to my auction purchase were in place because voters wanted me to be able to afford to buy more goods at auction, then it may not be a deadweight cost that I’m consequently able to purchase more goods at auction than I would have purchased in the subsidy-free environment.

Using the potential for altruistic externalities to deem fiscal externalities solely pecuniary effectively links the public together through a political transactional nexus such that these fiscal effects are no more an externality than would be an employer saving a bit of money at the employees’ expense by spending less on air conditioning. This move requires rather too much of politics as revealed preference arguments are difficult to apply in political environments.<sup>1</sup> Browning subsequently considers the case where the altruistic externality does not extend to behavioural changes induced by the subsidization of risk.

In the case where it is possible to accurately internalize the costs of individual risk-taking activities through Pigovean measures, the set of required taxes and subsidies will have incidence equivalent to actuarially fair private insurance premiums, albeit at much higher transaction cost. A fully public health system with comprehensive Pigovean treatment of health related behaviours would replicate that which would be achieved in a private insurance system where individuals were compensated through the tax system for their

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<sup>1</sup> Critiques made by Caplan (2001), Boudreaux (1996) and Lott (1997), among others, of Donald Wittman’s *Myth of Democratic Failure* (1995) apply.

baseline, non-behaviour related, health risk. In the public insurance case with Pigovian taxes on risk-taking, a person choosing optimally would choose the same level of risk as someone in a private system paying actuarially fair premiums for his risk-taking.

That does not mean, however, that we ought to prefer that such taxes be set. First, the largest effect of the public health system is to effect transfers from the healthy to the sick; behavioural responses to risk subsidization are relatively small. Klick and Stratmann (2006) find that state insurance mandates requiring that private insurers cover alcohol addiction treatment increase alcohol consumption by the equivalent of less than a drink per week on average. Similarly, Gelbach, Klick and Stratmann (2009) find that relative price changes of healthy and fatty foods account for very little of the rise in obesity over time. The plausible range of fat taxes to accurately internalize the external health costs of eating fatty foods is smaller than seasonal variation in relative prices between healthy and unhealthy foods; there is little observable effect of those relative price changes. Consequently, the elasticity of unhealthy food consumption with respect to the ability to offload health costs onto the government is unlikely to be very large, and the deadweight costs of excess risk taking are likely to be small.

Even if the financial costs of adverse health outcomes fall on government, individuals still retain fairly strong incentives to protect their own health. Being sick or injured isn't fun, even if somebody else is paying the bills. Or, think of it this way: by how much is your likelihood of participating in free rock climbing on high cliffs affected by how it affects your insurance premiums?

Second, where private insurers have strong incentive to ask hard questions about behaviours that seriously affect health risks, and to ignore those that are less important for calculating fair premiums, governments instead face reelection constraints. We would expect government to worry a lot about risky activities that garner social disapproval, or that are undertaken by politically marginalized groups, as compared to those that seem more meritorious. As smokers became more politically marginalized, excise taxes on tobacco have risen well beyond that which could be justified on fiscal externality grounds; smokers typically contribute more in tobacco taxes than they draw from the health system. Conversely, participation in risky sporting activities is unlikely to draw serious Pigovian attention.<sup>2</sup>

Third, if we want to worry seriously about the distortions in risk-taking behaviour induced by the existence of a public health system, it is likely to prove more efficient to provide a direct cash transfer allowing poor people to purchase private health insurance than to derive the comprehensive set of activities that would need to draw Pigovian taxation or

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<sup>2</sup> New Zealand's Accident Compensation Commission charges premiums to rugby clubs; the ACC has been critiqued for not setting actuarially fair rates – low risk clients subsidize higher risk clients – but a premium is nevertheless charged for some sporting clubs.

subsidy to push us to the optimum. The full list would be staggeringly broad and would require information elicitation that would prove difficult at best. There have been, for example, studies showing health benefits to moderate amounts of sexual activity, but health risks of engaging in risky sexual practices with multiple partners. In private insurance markets, if the firm would lose more profits by offending customers by asking them about their sexual habits than they would gain by having rates that more accurately reflected risk, the insurer will forebear from asking such questions. Governments could compel that some answer be given to highly personal questions, if not necessarily a truthful one.

Finally, implementing the optimal set of taxes would prove very difficult because the marginal health risk of engaging in risky activities generally varies with the quantity of the risky activity undertaken. For tobacco, the expected health risks are nonlinear and increasing: the optimal tax structure would then charge more for the second cigarette than for the first, and more still for the third. For alcohol, costs to the health system are decreasing for the first units of consumption, then sharply increasing. The optimal tax structure would subsidize consumption of the first daily drink or two but tax fairly heavily the fifth and subsequent drinks. Such tax structures simply cannot be implemented. Instead, light drinkers are overtaxed relative marginal external cost of their last drink while heavy drinkers are under-taxed. Even complex arrangements requiring swiping of a pass card for alcohol or tobacco purchase and levy taxes that varied with recorded individual consumption would fail where purchase can be separated from consumption through time or where individuals may choose to engage in private offsetting transactions to minimize total tax burden.

In short, even in the world in which the fiscal costs of risk taking are known and accurate, simply living with the behavioural distortions and transfers from the median risk-taker to those consuming higher risk may well prove optimal. But we are far from being in even that best case.

Of more direct concern is that transfers from the risk averse to the risk seeking through the public health system generates political demand for regulation or taxation of risk-seeking behaviour. Even if the subsidy to taking health risk had no efficiency consequence and individuals took on exactly as much risk as they would have taken on were they personally liable for health costs, the median voter may well have cause to grumble about the transfer if the altruism driving support for public provision of health services were generated more by concern for the “deserving sick”, who became ill despite taking the precautions that would have been taken by the median voter, than for those who did not exercise such care.

In this case, it is not the behavioural distortions generated by risk subsidization that generates voter demand for corrective measures but rather heterogeneity of risk attitudes combined with socialization of costs. Political markets are sensitive to pecuniary externalities (Holcombe and Sobel, 2001). The voter taking on the median amount of

health risk will resent paying the cost of those who drink substantially more, smoke, eat too much or fail to exercise – in short, those who have fun at the taxpayer’s expense – and will demand ameliorative policies even where those individuals’ consumption of risk is efficient. Socialization of the costs of risky behaviour fosters the development of meddlesome preferences.

### III. Healthism and Social Costs

The efficiency case for implementing Pigovian taxes or other regulations to internalize the excessive risk-taking that may be induced by government assumption of the downside costs of risky activities through the health system is at least defensible, if not perfect. The resulting Pigovian excise taxes may be second best. And while we know that collected excise taxes need not match the overall cost to the health system of any particular risky activity for the excise tax rate to be roughly correct, politicians and voters should not err egregiously if they reckon tax rates to be of the right order when those aggregate costs roughly match the aggregate excise take.<sup>3</sup>

So when confronted with studies claiming the “social costs” of drinking, smoking or gambling as being in the billions of dollars per year, even in a country as small as New Zealand, voters may understandably shift to demand more paternalistic policies as protection for their pocket-books. Despite media framing of these reports’ cost figures as representing the “costs to society,” or contrasting them with the aggregate excise tax take as a way of balancing transfer costs with transfer benefits, very few social cost measures actually measure either the aggregate external cost imposed by an activity or that activity’s costs to the public purse. And, even when the figures are constructed as costs to, for example, the health budget, the underlying method is typically at large variance from standard economic practice.

Economists have worked reasonably hard over the last half century or more to drill into introductory students that Pigovian taxation is a reasonable solution to externality problems, and that punitive excise taxation absent this kind of market failure has no

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<sup>3</sup> In the case of constant marginal external cost, an excise tax equal to that marginal external cost will both induce efficiency and result in tax revenues equal in magnitude to the aggregate external cost. In the case of nonlinear costs, there is no necessary relationship between a tax rate that minimizes aggregate excess burden and that tax rate that equates total tax collection with aggregate external cost of risk-taking. Any linear tax where external costs are nonlinear will tax too heavily moderate consumers relative to heavy consumers. If the point of the excise tax is efficiency, to minimize the excess burden of risk-taking rather than to compensate the fisc for its health outlays, then we also need to worry a lot about the elasticity of demand for heavy and moderate consumers of the risk. For alcohol, heavy drinkers are roughly sixty-three percent as price responsive as moderate drinkers (Wagenaar et al., 2009). Consequently, increasing alcohol excise taxes sufficiently to put appreciable dents into the excess burden imposed by heavy drinkers imposes a substantial excess burden on moderate drinkers who will underconsume relative to the optimum.

efficiency basis.<sup>4</sup> Unfortunately, while increasing numbers of voters have this passing acquaintance with economics, few can distinguish external costs from the kinds of costs presented in social cost studies. I here present one case study that is reasonably illustrative of the difference between economic notions of social cost and those used in what I'll call the *healthist* literature. It's also an important illustration of how these numbers work their way into public discourse and policy, even when sharply contested.

In April of 2009, the head of the New Zealand Law Commission, Sir Geoffrey Palmer, began citing the immense social costs of alcohol as requiring strong review of New Zealand's approach to alcohol (Palmer, 2009). He compared the social costs, tabulated by Business and Economics Consulting Limited (BERL) (Slack et al., 2009) at \$5.3 billion, with the aggregate excise tax take of some \$800 million and found the difference to be damning:

“It is an axiomatic principle of welfare economics that the costs engendered by an activity should be internalized to that activity. That way the allocation of resources is greatly improved because the consumers do not buy the product at a subsidized cost but at a cost that reflects the externalities the use of the product causes. This is the very reason we have the current excise tax on alcohol to prevent harm. But the gap between the current tax take of \$795 million for excise tax and the estimated alcohol costs in the BERL study - \$5.296 billion, is substantial.” (p.7)

Sir Geoffrey went on to propose measures that might bring the two measures into closer alignment.

If the BERL study had actually provided a measure of the external cost imposed by drinkers on non-drinkers, through crime, public health, car crashes and other such pathways, Sir Geoffrey would have been on reasonably solid ground in reckoning that the excise tax were rather too low. We cannot guarantee, of course, that excise taxes matching aggregate external costs ensures efficiency, as the marginal external cost varies too greatly by consumer, but it is not a bad rule of thumb.

But the BERL study was based largely on the method used by Collins and Lapsley (2008) in their estimate of \$15.3182 billion in social costs of alcohol in Australia. The Collins and Lapsley method in turn built on the method developed by Single, Collins, Easton et al (2003) and endorsed by the World Health Organization.<sup>5</sup> Cost studies built on the Single,

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<sup>4</sup> Barring, of course, Ramsey pricing. Strictly speaking, however, Ramsey rules suggest taxing more highly those goods that are complementary to untaxed leisure rather than simply those that are relatively inelastic in demand

<sup>5</sup> The first edition of the guidelines was published by the Canadian Centre on Substance Abuse in 1996 and included Single, Collins, Easton, Harwood, Lapsley and Maynard as authors.

Collins et al framework are not unique to the antipodes: a very non-comprehensive list includes Fenoglio et al (1997) finding a cost of 1,966 Franks (about 300€) per capita in France, Johannson et al (2002) finding a bit over that for Sweden, Rehm et al (2007) finding about 310€ per capita for Canada, and Rosen et al (2008) finding over 1500€ per capita for the United States. Collins & Lapsley's 450€ per capita Australian and BERL's 650€ per capita New Zealand measures are then not particularly out of line with other studies using the same method in other countries. This may not be surprising as one of the robustness exercises used in these papers is checking whether the per capita figure is roughly in line with those found elsewhere.

Numbers of this order ought to set off alarm bells. BERL estimated NZ\$4.794 billion in social costs of alcohol<sup>6</sup> in 2005/2006. The total health appropriation in 2005/2006 was NZ\$9.2 billion – roughly twice the reported social cost of alcohol. The total police budget was just over NZ\$1 billion for that year<sup>7</sup> while the total transport budget was \$1.3 billion. It's simply implausible that the external costs of alcohol are equivalent to half of total health spending and to more than twice the combined spending on police and roading, even if we include transfers as a social cost. Instead, the figure must include costs economists would normally dismiss as internal.

And, indeed, the BERL study followed the others in this literature in including a host of internal costs as part of the overall social costs of alcohol. Particularly egregiously in this case, the excise taxes paid by heavy drinkers were included as an external cost of alcohol.<sup>8</sup> It would be very difficult to bring this kind of a measure of external costs into balance with the aggregate tax take when every additional dollar in collected taxes raises measured external costs by fifty cents.

More thorough analysis of BERL's figures (Crampton and Burgess, 2009a,b) revealed that, of the \$4.8 billion in reported social costs, \$1.5 billion consisted of errors and loose method,<sup>9</sup> \$2.6 billion counted as costs drinkers impose upon themselves,<sup>10</sup> and only some

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<sup>6</sup> The greater figure cited earlier by Sir Geoffrey Palmer included the costs of alcohol used in combination with other drugs; the figure here cited includes only those costs listed as directly attributable to alcohol.

<sup>7</sup> 2005/06 budget figures sourced from the New Zealand Treasury at <http://www.treasury.govt.nz/budget/2005/estimates/est05sumtab.pdf>

<sup>8</sup> BERL corrected this error, though not others, subsequent to critique.

<sup>9</sup> For example, after tabulating the lost wages of a deceased, sick, absent or unemployed worker whose nonworking status was due to alcohol use, assuming that such workers would otherwise have been employed at average rates and wages, BERL multiplied those lost wages by 1.87 – the ratio of GDP to wages in New Zealand – and reported this larger figure as the costs of labour lost due to alcohol use. Using that multiplier is justifiable only under the assumption that the worker could never be replaced either by another worker, capital, or modified production process. If the worker

\$675 million could properly be viewed as net external costs of alcohol use – external costs of crime, fiscal externalities through health costs, and costs of road crashes. The aggregate excise alcohol tax in 2005/2006, at \$713 million, exceeded the external portion of BERL’s costs. Under a rule of thumb that excise revenues ought to approximate the external costs, New Zealand’s alcohol excise rate seems roughly correct.

Despite a few idiosyncratic errors in execution, BERL’s method sits well within the family tree of studies following Single et al. These studies follow what I will call a *healthist* approach to welfare analysis: according primacy to health over any other competing ends. As BERL stated:

“We assume that it is irrational to drink alcohol to a harmful level and that harmful alcohol use has zero private benefit. As such, the 50 percent of harmful alcohol consumption estimated in this study [half of all consumed alcohol was deemed consumed by harmful drinkers] has no private benefit to match the private cost, resulting in a net social cost. These private decisions that lead to social costs are included in our estimates.” (p. 173).

BERL used an *epidemiological* standard to determine whether a level of consumption could be rational. If a level of alcohol consumption brings with it increased risk of adverse health outcomes, that level of consumption is deemed irrational. One in six adult New Zealanders, consuming a daily average of at least 1.8 pints of beer, or half a bottle of wine, met the epidemiological standard for elevated risk and consequently were deemed irrational; their entire consumption consequently deemed without any private benefit. This view of rationality accords strict priority to health over any potential competing ends that individuals may seek.

The *healthist* method is hardly unique to BERL. The guidelines developed by Single, Collins et al (2003) suggest that while private costs falling on the individual consumer typically ought not to be counted in cost estimation studies, these costs can only be discounted where we expect there to be offsetting private benefits. With rational consumers, personal costs cannot exceed personal benefits and so private costs are not social costs. But what is necessary for rationality? According to Single et al:

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can never be replaced, the worker’s total product, including the contributions of capital, is lost. If the worker can be replaced, only the worker’s earnings are lost – a cost internal to the worker. We modified BERL’s figure by excising the multiplier, adjusting for the effects of comorbidity between alcoholism and mental illness on wages and unemployment rates, then apportioning costs between those internal to the worker and those transitional costs likely to fall on the employer. The use of the 1.87 multiplier added about \$700 million to BERL’s reported costs.

<sup>10</sup> Including the cost of consumed alcohol, lost wages, costs of premature mortality, costs of road accidents falling upon the drink driver and his passengers, and property damage.



“Thus, if the costs of substance use are to be classified as private costs, the following three conditions must be simultaneously satisfied:

1. The users are fully informed as to the costs which the substance use imposes upon themselves;
2. The users are required to bear the full (internal and external) costs of the consumption; and
3. The users make rational consumption decisions in the light of all the information available to them.

These requirements are extremely stringent, so stringent in fact that the conventional approach of treating all abuse costs as social costs is fully justified.” (p. 21)<sup>11</sup>

Under those conditions, I don't know that it's possible rationally to eat a banana, let alone have a drink or smoke. Nobody is ever fully informed about the costs or benefits of any action they undertake; rather, they act after having acquired an optimal amount of information. And our rational faculties can sometimes fall short of ideal. Ought we throw out all of consumer theory and welfare economics on the basis of minor deviations from these ideal conditions? Hardly.

But let's take the Single et al critique seriously. Suppose that a combination of information problems and irrationalities induces an individual consumer, who had planned on having a fully rational 1.75 pints of beer on an evening out, to instead consume a wholly irrational 2.25 pints. Ought we then treat his entire evening out as a social cost? No. Instead, we ought to count a portion of the last half pint as constituting excess cost.

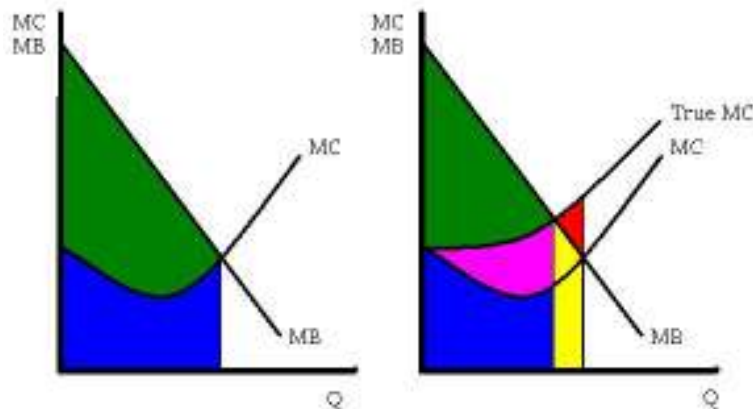
Consider Figure 1, below. The diagram to the left provides standard consumer welfare analysis for a rational, perfectly informed consumer. The marginal benefit curve, MB, traces the consumer's marginal benefit of each additional unit of consumption. The marginal cost curve, MC, traces the marginal cost of each additional unit of consumption, including both the constant purchase price of the beer and the health costs of alcohol consumption which reduce over the first units, reaching a nadir around one standard drink per day, then increase sharply above the health costs of teetotalling around three to four standard drinks per day.<sup>12</sup> The consumer chooses the consumption point at which marginal

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<sup>11</sup> Collins and Lapsley (2008) repeat this formulation at page 9: “Being fully informed about the private costs of abuse requires the abuser to have access to, and have the ability to process and evaluate, epidemiological information on the effects of drug use. It also requires the drug user to be able to evaluate the probable future health and other costs resulting from the drug use. It is difficult to believe that drug users, by their nature, are fully-informed, or even well-informed, about the costs of their abuse.” Contrast Collins and Lapsley, here, with Viscusi's (2002) finding that smokers overestimate the dangers of smoking.

<sup>12</sup> I summarize the literature on the “J-curve” at the blog Offsetting Behaviour, here: <http://offsettingbehaviour.blogspot.com/2010/03/moderate-drinking-and-health.html>

cost and marginal benefit are equated, generating total benefit of the green and blue areas at total cost of the blue area. The green area then is the consumer's net surplus.



On the right we have a poorly informed or irrational consumer who cannot tell that the true marginal cost curve, True MC, lies above the perceived marginal cost curve, MC. That consumer then drinks too much relative to what his better informed, more rational self would choose. But only the small red triangle above the marginal benefit curve and below the "True MC" curve is a true excess cost of his irrational overconsumption. The yellow trapezoid represents the costs of excessive consumption that are fully matched by benefits of excess consumption, while the purple area is a region of private cost that the consumer had expected would instead have been benefits. The green area remains surplus enjoyed by the consumer; net surplus would be measured by subtracting the red triangle from the green area. As long as the red area does not exceed the green area, the irrational or poorly informed consumer nevertheless remains better off for having gone out, despite having drunk a half pint more than he'd planned on having. He would have been better off, as he judges his own utility, had he consumed a bit less, but he still enjoys positive aggregate benefits.

If we followed Single et al's method, we would have to pretend that the marginal benefits curve coincided with the x-axis with any deviation from fully informed, fully rational consumption; the entire area under the "True MC" curve would then count as social cost. But simply pointing out the potential for poorly informed or less than rational decisions is not sufficient for assuming away the private benefits of that consumption. Even if we take Single et al seriously and worry about the potential for bad decisions, only the red triangle ought to count as being socially important. And when assessing the potential benefits of regulatory or taxation policies seeking to reduce these externalities, we have to weigh the benefits of their reduction against the costs of reduced consumer surplus for those who did not suffer internalty problems but could not avoid the tax or regulation.

Setting impossibly strict rationality and knowledge standards for allowing any private consumption benefits to count against private costs allows *healthist* cost studies to include

as social all of the private costs associated with consumption for those whose level of consumption exceeds an epidemiological standard. And counting private costs as social is essential for generating the very large numbers that can help influence public debate. The method endorsed by the WHO and implemented in cost studies around the world embeds paternalism into the figures by improperly adding in costs falling on the individual consumer, then presents those figures with a veneer of impartial, dispassionate, non-paternalistic economic science.

Paternalism asserts that the individual is not the best judge of his own best interest and that government policy moving individuals towards outcomes they would not have chosen for themselves can nevertheless leave them better off by their own estimation. Social cost measures based largely on the costs an individual bears due to his own actions are paternalistic by construction. If the individual were best judge of his own welfare, then the kinds of individual costs tallied in social cost measures – reduced earnings and poorer health – must be deemed worth the consumption benefits by the individual bearing them. Including these private costs requires taking the paternalistic step of supplanting the analyst’s assessment for the individual’s own. But the paternalism is made opaque.

Do these big numbers then help to build support for paternalistic policies? Of course. Despite the considerable media controversy surrounding BERL’s figure subsequent to its critique,<sup>13</sup> the New Zealand Law Commission continued to rely on BERL’s figure in its eventual report, buttressed by additional work by Australian consulting firm Marsden Jacob and Associates supportive of BERL’s general approach.<sup>14</sup> BERL’s \$4.8 billion figure features intermittently on the letters pages of the local newspapers and in features on New Zealand’s drinking problem.

In Australia, Collins and Lapsley’s estimate of the social costs of alcohol – using methods no less flawed – is cited regularly in both press and Parliamentary debate. The \$15 billion figure has been cited thirty times on Australian television, in news, current affairs, and talk shows; has been cited seven times on radio; has been used in at least twenty-six opinion pieces and editorials, generally in support of stricter alcohol policy; and, has appeared in an additional seventy-nine news stories. It’s also proved influential in Parliament, mentioned on twelve occasions by nine MPs from the Australian Labor Party, generally in support of increased alcohol excise taxes – particularly on “alco-pops”, and twenty-one times by five

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<sup>13</sup> The dispute was covered in The National Business Review, The Christchurch Press, Food Industry Week, Otago Daily Times, New Zealand Herald, Newstalk ZB; BERL report author Ganesh Nana was interviewed on Radio New Zealand to defend his figures.

<sup>14</sup> I critiqued the Marsden Jacob report at Offsetting Behaviour:  
<http://offsettingbehaviour.blogspot.com/2010/04/marsden-jacob-on-alcohol.html>  
<http://offsettingbehaviour.blogspot.com/2010/04/marsden-jacob-review-continued.html>  
<http://offsettingbehaviour.blogspot.com/2010/05/oia-and-marsden-jacob-report.html>

senators from the Greens, Family First, and Labor.<sup>15</sup> It is always possible that these cost measures have been inframarginal – that equivalent excise tax increases would have happened even in their absence. But it seems rather unlikely.

And, of course, *healthist* techniques couching paternalism as social cost go well beyond attacks on alcohol. Kersh and Morone (2005) document the rising moral panic surrounding obesity and argue that policy makers who were not moved by paternalistic arguments have found convincing budgetary arguments of the economic effects of obesity – costs of lost productivity, lost wages, lost future earnings totaling over US\$50 billion.<sup>16</sup> As these costs are internalized to the individual, it's simply paternalistic argument presented in opaque new garb.

Social cost studies presenting private costs as socially relevant build public support for paternalistic policy while hiding the policy's embedded paternalism. Voters take the cost measures as impartial measures of the cost they're called upon to bear due to others' actions and shift outward their demand for corrective measures. Equilibrium policy adjusts towards greater paternalism.

#### IV. Nudges and shoves

While social cost studies increase voter demand for paternalistic policy by exaggerating the benefits of policy, another technological innovation – the nudge – suggests that paternalistic policy can be implemented unobtrusively. Richard Thaler, the favorite for this year's Nobel Prize in Economics at New Zealand political stock market iPredict, and coauthor Cass Sunstein, now head of the Office of Information and Regulatory Affairs, argue that the systematic deviations from rationality identified by behavioural economists can form the basis for policy interventions that make individuals better off while leaving those individuals the opportunity to opt-out. For example, if individuals have a bias towards accepting default options rather than switching, policy should be set so that the default option works best for those who are least able to make informed choices among other alternatives while allowing individuals to make that choice. So the default option in retirement plans ought perhaps simply be an index fund.

In principle, nudge policies could be used to replace a good number of existing paternalistic regulations and consequently expand the range of overall freedom. For example, drug

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<sup>15</sup> I thank Brad Taylor for research assistance here; note that these figures are rather preliminary and constitute a lower bound of what will be found with further work. Full citations will be available on request.

<sup>16</sup> Kersh and Moore note, for example, a front-page Washington Post article arguing that “the non-obese are forced to subsidize the obese” and a Baltimore Sun editorial arguing that, because of fiscal externalities, “the size of your waistline may no longer be your own private business”.

prohibition could be replaced with a licensing regime where those not on welfare and who passed a basic knowledge test about the effects and addictiveness of different drugs would be allowed to purchase and use currently illegal narcotics after opting into a precommitment mechanism in which they specify, before taking drugs, how much they ought to be allowed to purchase later on.

Nudge policies have begun showing up in the UK, the US and Australia. David Cameron established a “nudge unit” in the UK Cabinet Office; Richard Thaler is reportedly advising them.<sup>17</sup> David Ferguson reports from America that Cass Sunstein’s OIRA position “is easily the most powerful regulatory position in the executive branch, after the president’s. Every significant rule proposed by every federal agency must win the approval of Sunstein’s office, which is now staffed with still more behavioral economists recruited from Harvard, MIT, Princeton, and the Brookings Institution. It’s like behavioral summer camp over there.”<sup>18</sup> The Australian proposal that gamblers using poker machines be required to carry smart cards with set daily gambling limits – “mandatory precommitment”, as Prime Minister Gillard put it – is a form of nudge policy.

While in principle not only reasonable but also potentially liberty-enhancing, nudges remain more than a little problematic. First, the economic theory on which they are based is strongly contended. Hyperbolic discounting provides the basis for many purported behavioural biases: individuals will weigh far too heavily the present relative to the near or distant future. Such behaviour is largely viewed as irrational. But while laboratory evidence exists for hyperbolic discounting in particular settings, Anderson et al (2010) find no evidence of substantial hyperbolically discounting behaviour in a sample of adult Danes. Findings of hyperbolic discounting may be fragile to choice of experimental subjects and laboratory settings. Levitt and List (2007) similarly urge caution in extrapolating from economic laboratory results to real world settings.

Second, if irrationalities plague individual decision makers, what reason have we to believe that policy makers are isolated from similar problems? Individuals may make errors, and policy choices may help them to avoid those errors, but biases in voter perceptions are certainly not unknown (Caplan, 2001b; Crampton 2009, among many others). These voter preferences are meant to be the basis for policy – nudge-based or otherwise. But we expect that voters at the ballot box will have weaker incentive to ensure that they have corrected for potential irrationalities and biases than they do when at the shopping centre: the costs of poor decisions are probabilistic and dispersed rather than certain and personal. Might we then wish for nudges at the ballot box? Where Sunstein and Thaler worry about our decisions over investment plans or our weakness of will at the buffet table, I worry

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<sup>17</sup> “David Cameron’s ‘nudge unit’ aims to improve economic behaviour.” Patrick Wintour, *The Guardian*, 9 September 2010.

<sup>18</sup> Ferguson, Andrew. “Nudge Nudge, Wink Wink” *The Weekly Standard* 19 April 2010.

about our decisions at the ballot box. We vote infrequently, there's no feedback from our personal voting decision to any policy outcome, the voting decision is complex and we may have little grasp of the issues at stake let alone our own positions on those issues. In prior work (Crampton, 2009), I found that only about half of New Zealand voters in 2005 could correctly place National, United Future, and Labour on a left-right spectrum, and that political ignorance affected policy and party preferences independently of the demographic correlates of that ignorance. Consequently, there is at least as good reason to recommend nudges at the ballot box as at the 401k form.

Under my proposed libertarian paternalist voting system, your electoral enrolment would be linked to your census details. You'd then answer a brief questionnaire when entering a computerized voting booth, and I'd tell you, through the computer's algorithms, for whom you should vote. Trust me: I'd be choosing the option that really would be best for you, if you only understood all of the policies supported by each of the parties and had a professional economist's understanding of the likely effects of these policies. You'd still be free to pick some other candidate or party, but you'd have to first reject the default choice I'd pick for you. The remaining options would then be presented in an order designed to maximize the chances of your choosing the next best option. If you find such a scheme vests rather too much power in the person who builds the algorithm, you might also have cause to worry about those who would nudge our private lives.

Even if the bureaus in charge of developing nudge-based policies were insulated from the irrationalities of voter preferences, we still would have no reason to expect that these nudgers would themselves be immune from the kinds of problems they seek to correct in the rest of us. We ought always be skeptical of models that seek to place the modeler as being above the fray. Whitman (2010) carefully details how the nudger is here subject to the same problems as are the objects of his attentions.

In addition to potential incentive problems induced by political reelection constraints and less than well informed voters, would-be nudgers also need confront a reasonably strong form of Hayek's knowledge problem. Simply put, potential paternalists require assembling knowledge to which they haven't access if they truly wish to make others better off as those others themselves would judge things (Rizzo and Whitman, 2008). This knowledge problem is one reason why social cost studies use epidemiological standards for assessing the level of consumption of harmful good consumption that is deemed rational: they simply cannot assess whether an individual's drinking is due to rational assessment of health costs against consumption benefits or due to irrationality, and so they assume irrationality and declare all to be costs.

Finally, if nudge policies deliver paternalism at lower cost, we may well fear the substitution effect: paternalism has become cheaper, so we may well purchase more of it. Whitman and Rizzo (2009) warn of paternalistic slippery slopes. A nudge policy may be put in place, sold on its relatively low cost, but replaced with a shove when the policy proves

less effective than hoped in achieving the paternalists' ends. The distance from nudge to shove may be short indeed: while "nudge" paternalists would recommend allowing gamblers to use precommitment devices to cut them off if they started losing too much money, Prime Minister Gillard's proposal makes precommitment mandatory. For all of the nudgers' protests that their technology is unbiased, it is far more difficult to think of cases where nudge policies have seriously entered into public debate as a way of rolling back existing hard paternalism rather than as a way of rectifying problems that paternalists had previously been unable to address through their prior regulatory mechanisms.

## V. Conclusion

In simple microeconomic terms, the demand curve for paternalism has shifted out due to perceived increases in the costs of letting people run their private lives as they see fit. Social cost studies, the methods of which embed paternalism by denying that individuals might just have objectives other than health maximization, present a seemingly scientific argument that strong regulation is needed to mitigate these social costs. These studies have become more prominent in policy debate as the health share of national budgets has increased. At the same time, behavioural economics seems to have provided a new low-cost technology for providing paternalistic interventions: the helpful nudge. This has pushed out the supply function. Equilibrium policy outcomes consequently become more paternalistic.

But there has been some recent retrenchment. The new Conservative / Liberal Democrat government in the UK initiated a process encouraging voters to name laws and regulations that they thought were in need of repeal, responding to the pushback against nanny-state intrusions. Cameron's 'nudge unit' was set up at the same. Unfortunately, its initial work, as reported in the Guardian, seems focused on using nudges to expand the range of paternalism rather than to give the older paternalism a softer face.

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