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PubPol 580: Reading Notes for Class 7 & 8 (Sept. 29 & Oct 1, 2009)

We will spend next week talking about the ethics of benefit cost analysis (BCA). There is a large amount of reading. For Tuesday read the chapter by Railton (up to the section entitled MEASURING COSTS AND BENEFITS), and start on Circular A-4 (say, pp. 1-31). Then finish Railton and A-4 for Thursday. And for comic relief whenever you need it, there is a spoof from an old New Yorker (made fresh again by Larry Summers' new position in government), a very funny segment from the Colbert Report, and a recent Dilbert (on discounting).

One topic for Tuesday is the relationship between ethics and BCA. The chapter by Railton addresses some key issues about benefit-cost analysis:

1. To carry out BCA, what must an individual believe about its scope?
2. What does an individual have to believe he or she is measuring when performing BCA?
3. What does one have to believe to discount future costs and benefits? (we'll do this on Thursday)

Then there is the relationship between utilitarianism and benefit-cost analysis. There are three kinds of tasks that face someone who wants to be a utilitarian and/or a benefit cost analyst: (1) the need to quantify consequences, (2) the need to monetize consequences (for BCA), and (3) the need to "utility-ize" consequences (for a utilitarian). A utilitarian could either assess utilities directly after step 1 or go through step 2 and then utility-ize monetary benefits. Think about some policies and the relative difficulty of these three tasks-which is most difficult (or leaves you feeling least confident in your judgment)?

Here are some points to provide background and food for thought about the moral standing of a benefit-cost analysis.

1. Both utilitarianism and benefit-cost analysis focus on consequences and forecasting consequences (for the most part the same consequences) is key to each enterprise. In both cases, the best action is the one that provides the greatest balance of good consequences over bad consequences. Where utilitarianism maximizes human welfare (measured in utility terms), benefit-cost analysis focuses on maximizing net benefit (measured in dollars).

2. Neither is sensitive to the distribution across people of the thing that's being maximized. That is, utilitarianism maximizes total utility and doesn't worry about how utility is distributed across people. Benefit-cost analysis maximizes net dollar benefit and doesn't worry about how monetary gains and losses are distributed across people. But there is a big difference between them. Utilitarianism IS sensitive to how dollar gains and losses are distributed across people. Other things equal, because we usually assume there is a diminishing marginal utility for money (or other stuff that matters), utilitarianism inclines

toward equal distributions (of overall resources) because moving resources from those who have a lot to those who have less will, other things equal, increase aggregate utility. Benefit-cost analysis, because it stops at the distribution of impacts in terms of dollars and doesn't go on to examine the utility implications of the impacts, is less sensitive to distributional issues than is utilitarianism. So it's worth thinking about when utilitarianism and benefit-cost analysis might be most likely to reach different conclusions about a policy proposal.

3. In general, it seems to me that if benefit-cost analysis has strong normative appeal it must be because it gets the same answer utilitarianism would. So if you have some doubts about utilitarianism, they probably transfer to benefit-cost analysis. And because of the point from the last paragraph, benefit-cost analysis may generate some additional doubts.

4. The logic of benefit-cost analysis involves a bit of sleight-of-hand relative to what utilitarianism would recommend. (Maybe that's an unfair characterization-maybe it's better to say there is something about the logic that you should be aware of and let you make the value judgment about it.) The Kaldor-Hicks criterion is the fundamental normative principle underlying benefit-cost analysis. It says (roughly) that a policy is "good" (an improvement over the status quo) if those who gain from the policy can compensate those who lose from the policy. The best policy is the one with the greatest net benefit. A critical part of the argument (and here is where my sleight of hand comment comes from) is this: under the Kaldor-Hicks criterion, a policy is good (relative to the status quo) EVEN IF the compensation isn't actually carried out. That is, it's a judgment based on hypothetical compensation--if the winners could hypothetically compensate the losers, then the action in question gets the "good" label from benefit-cost analysis even if the compensation isn't actually carried out. The logic appeals to the Pareto principle along the way (that if someone is made better off and no one is made worse off by a policy, then the policy represents a Pareto improvement for society). Suppose we start with status quo A. Policy B is proposed. A benefit-cost analyst demonstrates that it is possible from B to move some money from those who gain in the change from A to B to those who lose in that change, which results in a new outcome C, in which at least someone is better off than at A and no one is worse off than at A. Now by the Pareto principle C is clearly an improvement over A. And since B and C have the same net dollar benefit and differ only in the distribution of money (to which the net benefit principle is insensitive), B must also be "better" (in the eyes of this principle) than A. Note that a utilitarian has no quarrel with the comparison between A and C (C has to have greater utility since no one's worse off and at least one person is better off). But utilitarianism might not agree with the jump from "C is better than A" to "B is better than A"-because B and C are not necessarily equal in the eyes of utilitarianism. This step in the logic is really about being equally efficient, not equally "good" in any broader sense. It's likely to be the case that in many circumstances utilitarianism and benefit-cost analysis will reach the same conclusion. But they needn't. Do you think the normative power of saying a policy "passes the benefit-cost test" would be different if we instead limited ourselves to saying "the policy would increase economic efficiency"?

One way to think about the relationship of benefit-cost analysis and utilitarianism is the following. Let $d(i)$ be the net dollar value of the impact of a policy on person i . Let $MU(i)$ be the marginal utility of a dollar for person i . (And assume the $d(i)$ are relatively small so marginal utility can be treated as a constant.) The policy has a positive net social benefit if

$$\sum d(i) > 0$$

In this case, there will be sufficient net benefit that the winners under the policy could compensate the losers under the policy and everyone could be a little better off. So if this compensation is carried out, everyone has a net benefit. The Kaldor-Hicks criterion says that this policy is a good idea even if the compensation isn't actually carried out.

The policy increases aggregate utility if

$$\sum d(i) * MU(i) > 0$$

The two always yield the same result only if $MU(i)$ is a constant—which runs counter to the assumption that people have declining marginal utility for stuff (which is why indifference curves aren't straight lines). It is possible that a policy would pass the Kaldor-Hicks test but fail the utilitarian test and vice-versa. The most likely case would be when the largest dollar benefits go to those who are well off (and therefore have low marginal utilities for a dollar) and the costs are borne by those who are not well off (and therefore have relatively high marginal utilities for a dollar). Or when a project is an economically inefficient but very redistributive from rich to poor.

Finally, a note about professional judgment, which is central to professional ethics:

The importance of "professional judgment" comes up on a number of occasions in Circular A-4. One of the virtues of Circular A-4 is that it doesn't argue that BCA is a necessary and sufficient exercise for knowing what the right answer is. Its attention to distributional issues and its attention to doing sensitivity analysis as a way to see how critical various assumptions are provide some indications of what's wrapped up in professional judgment. What do you think this repeated reference to professional judgment is trying to accomplish? What are the principal virtues associated with professional judgment?

Several years ago the Bush administration inserted a new level of review into the regulatory process--a review by a partisan appointed official. The gist (from the NYT): "In an executive order published last week in the Federal Register, Mr. Bush said that each agency must have a regulatory policy office run by a political appointee, to supervise the development of rules and documents providing guidance to regulated industries. The White House will thus have a gatekeeper in each agency to analyze the costs and the benefits of new rules and to make sure the agencies carry out the president's priorities." We'll see if President Obama sticks with this structure (Cass Sunstein, his regulatory czar, is a considerable fan of benefit cost analysis). Presumably the political appointee is exercising something other than (or, charitably, in addition to) "professional judgment." Thinking

about what kind of judgment these two folks at the top of the regulatory pyramid are bringing to bear may help to shed light on what the virtues are we're looking for in the non-political official's judgment.