

Rick Freeman <rffreeman@bowdoin.edu>
03/31/2003 03:12:27 PM

Record Type:Record

To: Lorraine D. Hunt OIRA ECON GUIDE/OMB/EOP@EOP
cc: rffreeman@bowdoin.edu
Subject: Comments on the Draft Guidelines

MEMORANDUM

To: Dr. John D. Graham, Administrator, Office of Information and Regulatory Affairs, Office of Management and Budget

From: Prof. A. Myrick Freeman III, Research Professor of Economics, Bowdoin College, Brunswick, ME

Subj: Comments on Draft Guidelines for Regulatory Analyses

I. Favorable Comments:

A. Uncertainty: The requirements to characterize the key uncertainties and to perform quantitative probabilistic uncertainty analysis of rules involving costs over \$1 billion are welcome. But I think that there is more that needs to be said here.

Specifically, I recommend that you add a paragraph explicitly criticizing the practice of combining two or more conservative assumptions in the calculation of an "Alternative Estimate" of benefits, as has been done by EPA, for example in its economic assessment of the Clean Skies Initiative. By incorporating at least three conservative assumptions in one calculation, the Agency has produced an estimate of benefits that has a very low probability of being true. Or to put it differently, the Agency has focused on the uncertainties on the down side to the virtual exclusion of the uncertainties on the upside, thus producing a biased picture of the true uncertainty in the estimation of benefits. A formal probabilistic analysis of the uncertainties in the Base Estimate would almost certainly result in an upper bound that is higher than the Alternative Estimate. The Guidelines should explicitly rule out this approach to characterizing uncertainties.

B. Proposed Rules and Alternatives: It is good to explicitly require that regulatory analyses be conducted for more than one alternative to the status quo.

C. Ancillary Benefits: I applaud the explicit consideration of ancillary benefits.

D. Transparency: Transparency of the analysis and underlying assumptions is of critical importance.

II. Critical Comments (page numbers refer to the Federal Register Notice, February 3, 2003):

A. On p. 5514 in the 4th paragraph of the section titled “Why Analysis of Proposed Regulatory Actions Is Needed,” the last two sentences talking about “trump cards,” etc. should be deleted. The Guidelines should be dealing with analysis that supports policy making. But these two sentences talk about policy making itself. The use or nonuse of “trump cards” and the consideration of competing public policy objectives are policy issues, not matters of how to conduct good economic analysis.

B. The first sentence of Section III. B. should be revised to read, “Cost-effectiveness analysis can provide a rigorous ...(*italicized word added*).” For the reasons presented in the next sentence of the Draft Guidelines and below, CEA does not always provide useful information for evaluating alternatives.

C. At the middle of p. 5518, the Draft Guidelines say:

“Estimates of willingness-to-pay [WTP, hereafter] based on observable and replicable behavior are the most reliable.”

Reading this sentence in the context of the rest of this paragraph, I interpret it as meaning that estimates of WTP based on revealed preference methods are the most reliable. If this is the intended meaning, it should be stated directly.

But if that is the intended meaning, I have to point out that this is controversial statement. Revealed preference measures of WTP are sometimes quite sensitive to model specification and estimation techniques (see Freeman, 2003, pp. 461 for references). And some authors have reported favorable results of tests of convergent validity of stated preference and revealed preference measures of the same environmental resource (Carson, et al., 1996).

D. In the third paragraph of the discussion of Contingent Valuation (p. 5519), the Draft Guidelines refer to the “absence of observable and replicable behavior” in these studies. But this is inaccurate. The behavior of respondents in CV studies is certainly observable. The issue is that it is behavior (responding to questions, making choices) in a hypothetical setting. This should be clarified. Furthermore, this behavior is, in principle, replicable by drawing a new sample and asking the questions again. In fact CV studies have been successfully replicated. See for example, Carson, et al. (1997).

E. In the paragraph discussing health utility measures (last paragraph of Section IV. B. 8., a, p. 5521), it should be acknowledged that most of these measures are also based on responses to hypothetical questions. So they are subject to the same kinds of validity issues that stated preference measures of WTP face. And the record in testing these measures for validity has not been particularly reassuring.

F. On discounting on p. 5522, the Draft Guidelines state that the opportunity cost of capital rate (7%) from Circular A-94 “is the appropriate discount rate whenever the main effect of a regulation is to displace or alter the use of capital in the private sector.” This is not correct. As has been shown in several places (Kolb and Scheraga 1990; Lesser and Zerbe 1994; Freeman, 2003, pp. 203-204), the opportunity cost of capital is appropriate for estimating the financial impact of regulatory costs on firms. But the true welfare cost to individuals must be assessed in terms of impacts on consumption. And a marginal rate of time preference is the appropriate discount rate for making this calculation.

III. Omissions: The Guidelines should also spell out a requirement for performing regulatory analyses of proposed rule changes that result in less stringent standards or requirements and should describe how reductions in health and safety benefits should be identified as costs of such rule changes while cost savings for regulated parties are counted as benefits of rule changes.

References:

Freeman, A. Myrick III. 2003. *The Measurement of Environmental and Resource Values: Theory and Methods*, 2nd ed. Resources for the Future: Washington, DC.

Carson, Richard T. Nicholas E. Flores, Kerry M. Martin, and Jennifer L. Wright. 1996. Contingent Valuation and Revealed Preference Methodologies: Comparing the Estimates for Quasi-Public Goods. *Land Economics* 72(1):80-99.

Carson, Richard T., et al. 1997. Temporal Reliability of Estimates from Contingent Valuation. *Land Economics* 73(2):151-163.

Kolb, Jeffrey A., and Joel D. Scheraga. 1990. Discounting the Benefits and Costs of Environmental Regulations. *Journal of Policy Analysis and Management* 9(3):381-390.

Lesser, Jonathan A., and Richard O. Zerbe.. 1994. Discounting Procedures for Environmental (and Other) Projects: A Comment on Kolb and Scheraga. *Journal of Policy Analysis and Management* 13(1):140-156.