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March 11, 2009

Ms. Jessica Hertz
Office of Management and Budget

Re: Comments on Executive Order 12866

Dear Ms. Hertz:

The purpose of this letter is to provide comments in response to President Obama's required review of Executive Order 12866 with the objective of improving the process of regulatory review. In what follows I identify four recommendations for changes in the regulatory review process. Before describing these recommendations three points are identified as important background.

1. All Public and Private Decisions Reveal Implicit Net Benefits of Each Choice

This statement is one of the most fundamental insights of the revealed preference logic of economics. A decision to do something implies the gains realized from the action exceed the costs <u>from the perspective of the person making that choice!</u> Deciding to forego action also tells us the costs exceed the gains. This applies with equally to private and public decisions.

What is at issue with a federal mandate to undertake a benefit-cost analysis is the entity responsible for the choice must document how its assessment of gains and costs relates to <u>the individuals who will actually experience them</u>.

Regulations limit private choices in the public interest. In the absence of a requirement for a transparent, systematic, documentation of the <u>perceived</u> net benefits of each action, there is no assurance that regulatory agencies will consistently document and consider all of these implications. Indeed, some statutory mandates require that rules be based on other criteria. For example, the Clean Air Act mandates that the primary ambient air quality standards for the criteria air pollutants be set to protect human health with an adequate margin of safety. Furthermore the enabling legislation also specifically requires that costs should not be a consideration in setting these standards. The primary standards have also been interpreted as precluding the use of economic benefits for determining the standards. Comparable statutes that rely on a health based criteria can be found in other regulations.

Thus, a benefit-cost review does not imply regulations must be defined to realize positive net benefits. Rather, it encourages transparent documentation of the reasons for action when costs exceed benefits.

2. Eliminating A Requirement for Systematic Benefit-Cost Analysis Does Not Mean That Analysis of Benefits and Costs Will Stop

The revealed preference logic explained above assures that benefit-cost analysis take place regardless of a federal mandate. Indeed multiple benefit-cost analyses take place now for major rules.

The requirement assures a source of <u>objective data</u> and <u>systematic analysis</u> of rules that is in the public domain. There is no assurance the full details for how privately developed analyses (even from academic sources) will be available to the public.

3. <u>Scarcity Assures Priorities Will Be Established</u>

Resources will always be limited whether we define them in terms of time or other components of a society's productive capacity. Public and private decision making processes inevitably set priorities. Once they are established implicitly or explicitly it is essential to continuously monitor whether the actions taken are important. A benefit-cost mandate provides a transparent score card to gauge cross-agency priorities consistently.

<u>Recommendation</u>

(i) <u>Do Not Establish Constant Unit Values for Outcomes of Rules</u>

Some advocates of benefit-cost analysis have recommended a consistent set of unit values to be used for all agencies. This might entail, for example – one value for risk reductions in the form of a constant VSL (value of a statistical life) or one value for restricted activity days due to a morbidity effect.

There is no arbitrage mechanism that assures consistency in the tradeoffs people make in different sources of risk or health effects. The tradeoffs may reflect specific heterogeneous circumstances distinguishing each situation. Regulatory review should define and require that the unit values implied by their methods be measured, reported, and compared to consensus values in the literature. Differences would then be explained and the process would provide a transparent template for improving practice.

The only exception to this recommendation is a single constant value for the discount rate used to construct present value measures.

(ii) <u>Uncertainty in Estimates of Costs, Benefits, and Processes Must Be Documented Consistently</u>

This limitation is one of the most important shortcomings of all efforts to anticipate the consequences of actions before they are undertaken. There is no consensus in how we should treat uncertainty in the analysis of policy. We need a new paradigm to evaluate the treatment of uncertainty for public choices. A inter-agency committee of internal and external experts should be established to make recommendations for best practice in the treatment of uncertainty.

(iii) <u>Establish a Consistent Protocol for How Benefit Cost Results are Reported</u>

This protocol should include documentation of baseline or condition in absence of action and the time profile of outcomes with action. It should include provisions for:
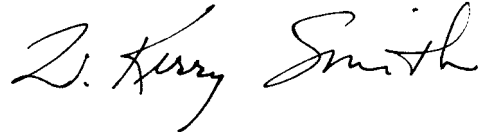
- Annual measures of physical outcomes
- Annual measures of benefits and costs
- Measures for the unit value of major effects or outputs affected by policies
- Measures of the incremental costs of activities required to meet rules
- Distributional effects by income groups and regions
- Source code to allow full assessment of assumptions

(iv) <u>Evaluate the Economy Wide Impacts of "Large" Policies</u>

The new order should require analysis to assess the general equilibrium and feedback effects for sectors and activities not directly affected by the rules.

I would be happy to discuss these suggestions and provide additional information.

Sincerely yours,

V. Kerry Smith
W. P. Carey Professor of Economics