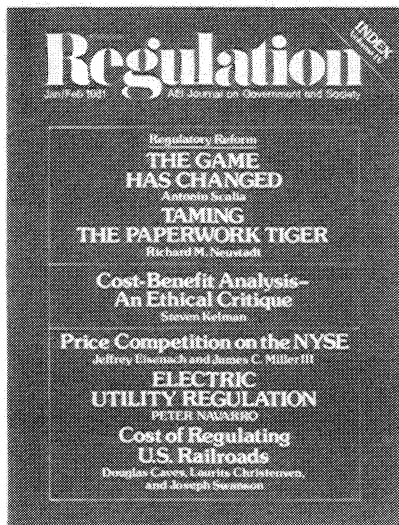


# Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.



## The Morality of Cost-Benefit

### TO THE EDITOR:

In "Cost-Benefit Analysis: An Ethical Critique" (*Regulation*, January-February), Steven Kelman elegantly savages a straw man—cost-benefit analysis as a necessary condition for public decisions about such matters as safety and health regulation. It is perhaps a timely savaging, for some important figures in the new administration use rhetoric that suggests the straw man looks real enough to them. Nonetheless, the position Kelman attacks would be defended by very few serious economists or policy makers. . . .

. . . What do we mean when we say things are "not for sale"? This may mean that the implicit price is either zero or infinite. Consider the

difficulty with the former. For example, some in the conservation and sporting communities argue that access to wilderness or good trout fishing or white-water rafting should not be for sale. Traditionally these things have not been for sale; they have been free to all comers at zero price. If they cannot have a nonzero price how do we protect them from us? In practice we adopt all sorts of nonprice rationing schemes, including permit lotteries, monopolistic or oligopolistic franchises, and (in the sporting example) restrictions on techniques and kinds of equipment. Do we really believe that these expedients are morally preferable to other systems that might involve closer analogues to competitive markets?

Then consider things that have an "infinite price" or are "priceless." This is no doubt a useful rhetorical device, as Kelman points out. But that does not make it any more helpful as a guide to real decision making. It is never so simple as better red than dead or vice versa. We are not confronted with a referendum or a bill in the Congress that requires an infinite appropriation and guarantees "the survival and success of liberty." Rather we are asked whether we want to spend an extra \$10 billion for this defense program; whether we want to cut or expand the foreign aid program; and what we think of energy independence in the form of massive syñfuels development. In this context, the cost-benefit analyst may be seen as a humble dustman, scurrying around after the famous, trying to clean up the tangle of rhetorical flourishes littering the ceremonial fields.

Thus I do not think Kelman's analysis is very helpful in principle. A more practical reason for concern with his prescription is that cost-benefit analysis does exist and will be used by proponents and opponents of programs and policies whenever they think an advantage can be gained. The current enthusiasm for cost-benefit analysis by opponents of environmental and health and safety programs reflects

their judgments about the balance that is likely to turn up, not their commitment to this tool as a necessary condition for public decisions. In the present condition of the field, they are likely to be right, since our skills in benefit estimation for environmental and health and safety programs are rudimentary, and the highly technical nature of much of the argument makes it easy for any given economist to criticize the estimates of any colleague. Enough demonstrations that costs swamp benefits or that there is no agreement on any benefit estimate will, especially in our gloomy economic climate, erode support for the special-thing or infinite-price arguments repeated by Kelman. When these bastions crumble there will be no fallback position and the retreat will be hard to stop. Even as a tactical matter, then, it behooves those of us who care about such things to try to advance the field rather than ignore or suppress it.

Clifford S. Russell,  
*Resources for the Future*

### TO THE EDITOR:

. . . After considering the interesting philosophical puzzlements posed by Steve Kelman's article, one is still left with a real and practical problem—what guidance are we to give those stewards of the public purse who make critical policy decisions? Are we to advise them not to use cost-benefit analysis? Instead of examining the potential consequences of their actions, should these analysts rely solely on their moral wisdom to determine such things as the proper wording on warning labels, the basis for requiring disclosures by used-car dealers, or the steps to be taken to reduce the incidence of cancer when carcinogenic chemicals are processed? While we might wish the wisdom of Abraham Lincoln for each of these analysts, we may doubt that such insight will emerge in sufficient abundance to preclude the need for a tool like cost-benefit analysis.

When decisions previously made by countless individuals on the basis of millions of market transactions are centralized, we face the impossible task of describing explicitly behavior which no one has written down. A decision to regulate carries with it a responsibility to account for regulatory actions. We move from a society formed by human action to one constructed by human design, a move that brings us to cost-benefit analysis.

Thus, Kelman's concern with cost-benefit analysis or any other move toward constructivism may in fact be a concern with too much regulation. If so, his desire that less emphasis be placed on such techniques may be fulfilled as efforts are made to remove the blanket of regulation which covers so much human action. But some regulation will likely survive. And if so, will we leave the regulator to make private moral judgments, or will we ask for some description of how he has arrived at his choices?

Proponents of cost-benefit analysis do not generally recommend it as the decision device. Instead, they offer it as a tool to assist decision makers when they deal with the collective welfare of society. A cost-benefit analysis can generate useful public discussion, a conflict of ideas that may yield an improved decision. But perhaps even more important, it reserves society's moral judgments for issues of the most profound importance, such as whether or not to regulate in the first place.

Bruce Yandle,  
Clemson University

STEVEN KELMAN responds:

I would like to respond both to these letters and to the four earlier replies to my article (*Regulation*, March/April). The thoughtful comments of my critics provide a basis, I hope, for a fruitful dialogue on regulatory decisions.

Let me start by noting where my critics and I agree. We agree that decisions about what levels of regulatory protection to require are difficult ones. We agree that consequences of decisions should be sketched out and analyzed systematically. We agree that explanations for decisions should be given, so that decision makers can be accountable for the balancing judgments they make.

I mention these areas of agreement partly because a number of those replying to me suggest that to criticize cost-benefit analysis is to attack the above propositions. If all that cost-benefit analysis did were to systematically sketch out the effects of regulatory alternatives and explain why a certain alternative was chosen, it would hardly be the powerful tool that "regulatory reformers" clearly believe it to be. EPA and OSHA, for example, have long carried out such analyses and explanations.

Honesty requires us to recognize that cost-benefit analysis implies more: It implies a rule ("maximize net benefits") that dictates, or very strongly suggests, *what decisions should be made at the end of the analysis*. It also requires, if the rule is to be applied, reducing costs and benefits to a common metric for purposes of comparison.

James DeLong is correct to note that I spoke of rights as an alternative to the "maximize net benefits" test as a justification for decisions. In this brief space, I can only suggest the outlines of an argument regarding the nature of rights. The notion of human rights rests, I think, on the suggestion that all people may legitimately make certain claims simply because they are human beings. The strength of a claim to a right is therefore based on the strength of its connection to the maintenance of human life, human dignity, or the elements of our common humanity (such as the ability to reason) that make humans unique among forms of life. Since this basis of claims to human rights is something we all share equally, there is also an egalitarian thrust to the notion.

*Proponents of cost-benefit analysis offer an entirely different test for the strength of a claim:* They ask whether the cost of meeting the claim is greater than the claimant's willingness to pay for it. But rights such as those to freedom of speech are granted on the former basis, not the latter, which is why we do not do cost-benefit analyses of the Bill of Rights. Costs, and the willingness to pay of various parties, are part of any moral deliberation, but far from the *only* factors. There is where I profoundly differ from cost-benefit advocates.

On the issue of the common metric, Clifford Russell asks whether I believe that refusing to place a dollar price on non-market things really is "morally preferable to other systems that might involve closer analogues to competitive markets." I do indeed, in many cases. My reasons are developed in part in my article and at greater length in my forthcoming book, *What Price Incentives? Thoughts on Economists and the Environment*. The very process of monetizing many non-priced benefits has great costs. In some instances these costs include moral costs, because the values diminished may be those of human life or human dignity, the basic units of ethical discourse. If I thought that the benefits of such monetization were overwhelming, I

might justify the practice. But I do not think they are.

James DeLong notes that "I may specially value a family relationship, but how often I phone is influenced by long-distance rates." I must confess that my reaction is: "So what?" If he means to suggest that we should put dollar values on family relationships, then he ought to make this argument explicitly. He doesn't, and therefore I fail to see the significance of his point.

Robert Solow notes that using units of measurement other than dollars might reduce the costs of monetizing non-market things. This is an interesting point. But all except one of the arguments my article makes against monetizing non-market benefits would hold just as well if the accounting unit were doughnuts. Only my last argument—that the process of pricing can itself diminish the perceived value of the previously non-priced thing—is partly dependent on dollars as the unit of account. I believe that part of this decrease comes from the very fungibility of *any* standard unit of account. Many years ago, Emile Durkheim argued that the very nature of sacredness is that we do not treat the sacred thing in ways that we treat the normal run of things. I also believe that if some unit of account other than dollars were invented for use in cost-benefit analysis, similar problems would soon attach to this new unit.

Finally, a number of my critics suggest that I attacked a "straw man." Much of Solow's reply, for example, argued not so much against points I made as against the idea that any serious advocate of cost-benefit analysis would suggest a simple decision rule of maximizing net benefits.

I urge Solow to look at cost-benefit analyses economists have done, say of OSHA regulations, in search of the kind of recognitions he says all serious practitioners accept. President Reagan's executive order states that regulation "shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society" and that "[r]egulatory objectives shall be chosen to maximize the net benefits to society." The "straw man" does indeed seem real.

If my comments serve to chasten cost-benefit enthusiasts about the ethical implications of methods they appear to feel are mere "neutral science," I believe I will have achieved an important purpose.

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## Electric Utility Regulation

TO THE EDITOR:

In his "Electric Utility Regulation and National Energy Policy" (*Regulation*, January/February), Peter Navarro points out that, because state public utility commissions (PUCs) have granted electric utilities inadequate rate relief, many electric utilities have failed to convert their power plants to non-petroleum fuels and have continued to burn oil, much of which is imported from OPEC. Furthermore, he warns that, unless state commissions allow electric utility rates to rise, federal intervention to protect the national interest is warranted. The article seems to support past Department of Energy policies (excluding oil price control) by asserting that any action designed to reduce oil imports is ipso facto in the national interest. Unfortunately, if we were to adhere to such a criterion and judge energy policies essentially by the number of barrels of imported oil they save, serious distortions would arise.

The article places too much blame on the state commissions for the country's continuing dependence on foreign oil and too little on the federal government, particularly its price control policies, which Navarro admits have been the "primary villain." The article's view of state regulators is similar to that of the Public Utility Regulatory Policies Act (PURPA), which has required state commissions to implement or at least consider five rate-making and six regulatory standards. The act has partly displaced the discretion of state commissions to place a priority on ratemaking issues.

State commissions are concerned that electric utilities are not earning a fair rate of return. And most of them are studying the likely effects of the changes Navarro recommends—allowing utilities to include construction work-in-progress (CWIP) in the rate base, to use a future test year, to "normalize" deferred taxes and investment tax credits, and to reduce regulatory lag. State commissions are now in a transitional period, evaluating the adequacy of their past policies in today's inflationary environment. . . .

But I do not agree that granting more rate relief is necessarily in the long-run best interest of consumers. For example, if we allow utilities to use a future test year, they may, un-

der plausible situations, inflate their costs in order to meet their earlier projections and consequently make their future projections more credible. Allowing CWIP in the rate base may not be in the best interest of consumers except under specific circumstances. . . .

Three factors explain the delay, and in some cases the cancellation, of new power plants construction: the slowdown in the expected growth of electricity usage, environmental standards, and financial problems. The first two have probably been more important than the third; certainly the Nuclear Regulatory Commission has been the number one hindrance to the completion of nuclear plants. The author would have been more convincing if he had offered statistics showing that delays in plant construction are longer or more frequent in states where the regulatory climate is "unfavorable." Instead he merely infers, without empirical evidence, that many delays are caused by the worsening of the utilities' financial condition.

It is true that many state commissions have not allowed electric utilities to earn a fair rate of return. That is a problem that only the state regulators themselves can solve. Federal intervention would only muddle the process. The most effective way the federal government can reduce our dependence on foreign oil is to streamline nuclear licensing and to avoid interfering with the operation of the marketplace.

*Kenneth W. Costello,  
Staff Economist,  
Illinois Commerce Commission*

TO THE EDITOR:

Peter Navarro's article is built on four unarguable propositions: (1) the current financial condition of much of the electric utility industry suggests that investors perceive significantly increased risk; (2) the policies of utility regulatory commissions will be reflected in the interest utilities will have to pay on new borrowings and the price they can command for their stock; (3) if companies can borrow only on unfavorable terms, or not at all, and if they cannot issue more equity without diluting the value of existing shares (because the market price is well below the book value), they are not likely to build the plants that could help cut the nation's oil consumption; and (4) it is highly unlikely that the industry can be

quickly restored to the financial strength it had in the 1950s and 1960s.

This last proposition led me some time ago to Navarro's view that federally financed conversion of oil-fired power plants to coal is needed to achieve the pressing national objective of reducing oil consumption. And the "bailout" objection that Navarro cites as a major obstacle can be overcome. Since the Department of Energy has itself judged that the operating savings from conversions will in fact exceed their capital cost, all that is required is that the government undertake to guarantee that judgment.

More specifically, the federal government would advance to utilities the capital necessary to carry out the coal conversions it deemed desirable. State regulatory commissions would be required to fix utility rates *after* the conversion as if oil were still being burned, and the difference between the revenue produced by these rates and the revenue the utility needed to cover its *actual cost* of operation—now presumably lower because coal is cheaper than oil—would enable the utility to repay the federal government for its advance. When the advance was repaid in full, rates would be adjusted to cover actual fuel costs. . . .

Consumers could be no worse off under this scheme than if coal conversion had never been attempted. If a conversion, subject to federal oversight, did not produce operating cost savings sufficient to cover all of its capital cost—because, for example, a change in federal environmental, safety, or transportation regulations resulted in dramatic increases in the cost of producing electricity with coal, or even precluded the use of coal at certain locations—consumers simply would not repay the full federal advance. But only in this presumably unlikely case would the advance become a partial grant.

A good long-run answer to the problem of fostering proper electric utility investments is not so clear. Perhaps Navarro's regulatory reform proposals (which are not new) are the solution. But his implicit thesis is that the variables he has identified determine decisions on the issues presented by the "six objective financial criteria" that make up a "regulatory environment." That suggests that the issues themselves are substantively uncontroversial. This would come as a great surprise to the many professional economists, accountants,

financial analysts, and lawyers who have been arguing about inter-generational equity, due process, efficiency incentives, and other concerns they see in these issues.

If Navarro had demonstrated that these concerns are unwarranted or unimportant, or that they must be sacrificed in order to achieve the proper level of investment, his proposed long-run solution would be more persuasive.

*Charles A. Zielinski,  
New York Public  
Service Commission*

#### TO THE EDITOR:

Contrary to what most consumer groups believe, Wall Street does not assess the regulatory environment of a utility solely on the equity return it is granted. As a former member of the Texas Public Utility commission and one of its three original appointees in 1975, I discussed the Texas regulatory environment with Wall Street groups on several occasions. An officer of Standard and Poor explained to me that his group was as wary of too-generous rate decisions as they were of inadequate ones. Either extreme resulted in uncertainty—Wall Street's greatest dread.

I agree with Navarro that decisions aimed at pleasing consumers often give them only a fleeting advantage, while leading to low bond ratings for the company. Adequate rate relief in the long run brings about lower financing costs and, eventually, more stable costs, even though it means higher rates in the interim.

*Alan R. Erwin,  
Dow Chemical*

#### TO THE EDITOR:

... There is a technical flaw in Peter Navarro's analysis that warrants a comment. Navarro states, "One measure of the cost of equity capital is the utility's M/B ratio, the ratio of the market price of a utility's common stock to its book value" and "[i]n general, the lower the M/B ratio, the higher the cost of equity capital." He then goes on to cite some evidence that relates quality of regulatory climate to M/B ratio and infers that as the quality deteriorates, the cost of equity goes up.

This line of reasoning is faulty. The market-to-book ratio essentially reflects the market's anticipated rate of return relative to its re-

quired rate of return and will be equal to one if the two coincide. The latter is the "cost" of equity capital and is determined by investors' risk perceptions and their time value of money. It may differ significantly from one utility to another. Now since the principal determinant of regulatory climate Navarro cites is the rate of return allowed by the PUC in recent cases, which is presumably a proxy for anticipated future allowed rates of return, it is not surprising that Trout and Navarro both found that the M/B ratio correlated with the regulatory climate index. But nothing about the absolute value of the cost of equity capital can be concluded from this correlation. If the market requires a higher rate of return from one utility than from another, the former will have a higher cost of capital than the latter. This is so even if the former is allowed by its PUC to capture a higher share of its required return than the latter—and thus attains a higher M/B ratio. Thus the M/B ratio is *not* a measure of the cost of equity capital.

In spite of this minor misconception, the essence of Navarro's argument is still valid. There is a negative relation between the cost of equity capital and the quality of regulation, but the causal mechanism is via risk reduction. An investor who believes a state commission to have the intellectual capacity to recognize that politically palatable short-run decisions may have very costly long-run consequences, and believes the commission to have the integrity to make the unpopular decision, will expect a more stable income stream. Such an investor will require a lower risk premium, and thus the cost to the utility of equity capital will be lower than it would otherwise be.

*Jerome E. Hass,  
Cornell University*

#### PETER NAVARRO responds:

I can hardly disagree with Erwin, who constructively clarifies issues on which we totally agree. Nor do I find much fault with Zielinski's eloquent defense of federal aid for oil displacement. I do, however, wish to disavow any "implicit thesis" that regulatory policies have no implications for equity, efficiency, and law.

Hass's argument that the M/B ratio is "not a measure of the cost of equity capital" is one on which

reasonable economists have differed. Rather than make the technical case that the M/B ratio is a good proxy for the cost of equity capital, let me note a misreading that has led Hass astray: He says that "the principal determinant of regulatory climate Navarro cites is the rate of return allowed by the PUC." In fact, I named five other criteria that help determine regulatory climate.

Hass then argues, however, that the allowed rate of return is "a proxy for anticipated future allowed rates of return," so that it is "not surprising" that the M/B ratio correlates with regulatory climate. Since this leap in logic is not based on what was in my article, I find his conclusion ("Thus the M/B ratio is *not* a measure of the cost of equity capital") to be more confusing than persuasive.

I totally agree with Hass that an unfavorable regulatory climate raises risk and therefore the cost of capital through risk premiums. That is precisely why utilities with "unfavorable" regulatory climates tend to have lower bond ratings.

Turning to Costello, I sympathize with his defense of PUC members, who after all sit on the hot seat of public opinion; and I am only slightly less fearful than he of federal intervention to solve utilities' financial problems. On the other hand, I do not consider displacing oil to be "ipso facto in the national interest." When oil passed \$30 per barrel in 1979, however, it became economic to displace fully two-thirds of our base load oil capacity. No "serious distortions would arise" from doing that; indeed, ratepayers would benefit.

His concern that allowing utilities to use a future test year might let them inflate costs ignores a primary role of PUC members such as himself—monitoring costs. It is easy to return any overcharge to consumers at the end of the rate year. The alternative, using a historic test year, is partly to blame for the large gap between the allowed and the realized rate of return of many utilities.

Finally, I simply disagree with his view that financial problems have played less of a role than sluggish demand in curbing new power plants. In many oil-dependent areas it is cheaper to build new capacity than to continue operating oil plants even if there is zero load growth. Many utilities, to be sure, are forgoing new plants in the name of conservation, but the underlying problem is financial. ■