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Benefit-Cost Analyses of Governmental Programs: Elusive Illusions of Science

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Greetings from Monaco. My colleague Professor Stephanie Kelton and I have just presented at the 9th Annual meeting of CIFA (Convention of Independent Financial Advisors). One of the other speakers in Monaco was Daniel Mitchell, a Senior Fellow at Cato. Dan and I come from very different views of economics, so we agreed that the fact that we agreed about a great number of things we believed were grave flaws in our financial system is a sure sign that the Mayan forecast of imminent catastrophe is likely to be correct.

One of the points Dan made about benefit-cost analyses and financial regulation sparked me to do some research. That research prompted this column. Dan urged that financial regulation should not be adopted unless it passed a formal benefit-cost test. SEC Commissioner Troy Paredes has been a strong advocate of requiring every proposed SEC rule to pass such formal tests. Dan implied that financial regulations are not normally subjected to formal benefit-cost tests and urged that no rules be adopted that did not pass a formal benefit-cost analysis. I taught how to conduct benefit-cost analyses for years when I was a professor at the LBJ School of Public Affairs at the University of Texas at Austin. There are several valid critiques of relying on formal benefit-cost analyses to decide regulatory policy. The next column will focus on a new critique arising from a nugget unearthed by my research into the extraordinary narrative that the most prominent proponent of benefit cost tests used to try to promote the use of such tests. I will show how revealing that narrative was in unintentionally demonstrating the great truth of the theme of CIFA's 9th annual meeting – ethics are essential in preventing policy disasters.

Theoclassical Economists Despise Government Programs, particularly Successful Regulation

Benefit-cost tests are used as a device to give theoclassical economists extraordinary power to block regulations disfavored by the ruling administration. A regulation on pollution, for example, is typically shaped by scientists and engineers because they have the relevant expertise and they use that expertise and experience to reach a judgment that the policy they are recommending will benefit the nation. Economists, however, are the purported experts on formal benefit-cost analyses and they can and do use that expertise to kill rules the scientists believe to be vital. Theoclassical economists are implacably hostile to regulation, so benefit-costs reviews could serve as a “choke point” to protect their dogmas – no matter how irrational and anti-empirical those dogmas prove. The core, defining dogma of theoclassical economists is that government is the problem, not part of the solution. They believe government is rarely necessary, that it proves a grave danger to personal liberty, and that virtually all governmental programs are economically illiterate and harm the intended beneficiaries as well as the economy. In short, they are potentially the perfect hanging jury when it comes to judging regulation. Indeed, the economists get to set the rules of the trial and via cost-benefit analysis they can override the agency decision-makers through their ex parte analyses. That makes them potentially more akin to a star chamber, able to condemn vital regulations essential to deal with about matters they do cannot comprehend. Consider the cognitive dissonance a theoclassical economist would have to endure if he conceded that a proposed rule would provide large net benefits. The theoclassical economist would have to repudiate everything he believed, professed, and admit that his dogma was false and had caused grave harm to the nation. Research has confirmed that cognitive dissonance creates powerful biases – and that we are typically unaware of and deny the existence of those biases. Theoclassical economists are infamous for claiming that there are pure “positive” “scientists” devoid of dogma – the most dangerous and self-deceptive form of intellectual denial.

The implicit intellectual proposition underlying this choke point is: economists have a universal, superior methodology for judging the desirability of public policies even in fields in which they are hopelessly ignorant. (Hint: those claims of superiority have never been subjected to scientific analyses or even non-circular benefit-cost analyses. They have failed the predictive test spectacularly again during the current crisis. The superiority proposition is implicit because if economists were to state it explicitly outside their own departments they would be laughed out of the room. False, implicit assumptions pose grave dangers because we do not even consider whether they are accurate.) Failed economic dogma leads to failed amateur climatology

With regard to policies to counter human-generated global climate change, theoclassical economists have no relevant expertise, no relevant experience, and a raft of unacknowledged personal biases arising from their anti-regulatory ideologies – a trifecta of tragic ignorance and arrogance. In other writings these same economists denounce policy makers who substitute their economic judgments for those of professional economists, so the theoclassical economists posing as amateur climatologists are also hypocrites. The only thing more pathetic, arrogant, and dangerous than theoclassical economists purporting to be superior, objective judges of the net benefits of programs in which they lack relevant scientific expertise and experience is the theoclassical economists trying to play amateur climatologists. They don't even stop to consider why they are engaged in such a facially absurd endeavor, one that, under their theories, imposes severe opportunity costs on them and society. I call it the theory of comparative disadvantages, a condition economists are supposed to abhor. Theoclassical economists are drawn to climate change denial, however, because it is an example of a devastating negative externality that a theoclassical economy will produce and cannot address successfully. It is a myth that lemmings commit mass suicide by jumping off cliffs, but theoclassical economists would do so if we didn't stop them. The broader problem is that they would drag us over the cliff with them. Theoclassical economists must deny human-induced global climate change, or at least deny its harms. They can't deny that greenhouse gasses can raise heat levels. They can't deny that what they describe as a “successful” “free market” would cause greenhouse gas releases to increase enormously. They cannot meet the weakest straight-face test if they deny that this would logically lead to climate change. They cannot meet the weakest straight-face test if they deny that this would create large, negative externalities. They cannot meet the weakest straight-face test if they claim there is a successful “Coasian” “solution” to these negative externalities.

The theoclassical economists are left with only two possible ways of addressing the growing crisis, which is insoluble by the pure “free market.” Only one of those possibilities does not require them to engage in apostasy – an inherently benevolent nature self-regulates Earth. The search for some natural self-regulating analog to Adam Smith's "invisible hand" has led some theoclassical economists to hope that the visible cloud might save the now dangerously errant "invisible hand" that is guiding the economy in the direction of global climate change. The climate change deniers' best hope is that as the world heats up more clouds will be generated. The clouds will raise the Earth's albedo and increase the reflection of some of Sol's radiation back into space. Our great grandchildren may never see the sun again, but Seattle's residents already have to learn to love unbroken gray skies for 200 days every year. They have to drink a lot of high caffeine coffee to escape the resultant torpor, but some sacrifices must be made. Life does exist because some aspects of physics are self-regulating even over exceptionally long time periods. A star of the size and elemental composition of Sol is remarkably stable – or evolution would never have had time to produce us. Sol's thermonuclear generated expansionary pressures have balanced the contracting pressures of gravity for billions of years, and should continue to do so for billions of more years. (Sol still has hydrogen to burn.) Argentines have a saying that God puts right each night all the things Argentines screw up each day. Perhaps that's how nature works when it comes to greenhouse gasses. Go tell it to the Venusians. It's a preposterous gamble to take. Neoclassical economists' desperate attempt to save their failed, lethal, and ultimately suicidal faith-based economics model has required their descent into faith-based science. Benefit-Cost Studies are Not Objective Computational Exercises

Second, benefit-cost analyses reinforce theoclassical economists' illusion that they are engaged in a value-free, objective, and scientific exercise. Benefit-cost analyses of regulations are not objective, computational exercises. Every nation employing benefit-cost tests is subjective and biased in what programs it subjects to benefit-cost analyses. One might think that if formal benefit-cost analyses were really scientific and a critical discipline on policy-makers we would be particularly vigilant in requiring its use the more important the policy was. The opposite is often the case. No one conducts formal benefit-cost analyses before deciding to go to war or avoid doing so (e.g., the decision not to intervene in Rwanda to try to prevent the genocide). No one in the U.S. government requires our endless "drug wars" or aspects of our "wars on terror" to pass a formal benefit-cost analysis. No one does a formal benefit-cost analysis before launching a successful raid to kill Osama bin Laden. Commanders carefully considered the benefits and costs of launching the raid, but they correctly understood that relying on formal benefit-cost studies by economists would harm the decision-making process.

The drug wars provide a useful case study. Theoclassical economists, like criminologists overwhelmingly think the drug war is insane. It cannot succeed. The phrase "war on drugs" declares an endless war we can never "win." The direct costs this unwinable war imposes on the U.S. in terms of economics, mass imprisonment of disfavored minorities, and loss of liberty are extreme. The war imposes catastrophic costs on other nations. The drug war makes our enemies in the (also perpetual) "war on terror" wealthy and able to kill us and our allies. The drug war is a failure. No one serious who studies the subject thinks it can be won, which is why no one even bothers to define what it would mean to "win" the "war on drugs" or the "war on terror." Again, I emphasize that theoclassical economists are generally strong opponents of the drug war and many of America's attacks on other nations apparently undertaken under the rubric of the "war on terror." The point is that they know that benefit-cost analysis is used selectively to kill regulations and is never used to kill these disastrous wars. The Koch brothers are good with this asymmetry and the hundreds of theoclassical economists they and their allies support are willing to let the asymmetry continue and pretend that the benefit-cost process is objective. Benefit-cost analysis of important public policies is never a computational exercise. One is always operating in conditions of uncertainty. The data are always incomplete and imperfect. The indirect costs and benefits are typically neither known nor knowable and are not quantifiable. The indirect costs and benefits will often be far larger than the direct costs and benefits. Estimates, even if made in good faith, of long-term projects, are particularly suspect. The Bush administration's estimates of the costs of invading and pacifying Iraq ended up being wrong by several orders of magnitude. The benefits of invading Iraq are bitterly contested. One could make credible arguments that there were none, but some former Bush officials have argued that while there were no weapons of mass destruction in Iraq and the Iraqi government did not support anti-U.S. terrorists, our invasion triggered the ongoing Arab popular revolts. The benefits of those revolts are also sharply contested. Did our invasion of Iraq increase Iran's regional hegemony and spur a decision to develop nuclear weapons? If so, how would one measure those costs? The truth is that these numbers are uncertain and that economists are more likely to detract than add to the reliability of numbers if they start substituting their judgment for the generals' judgments. All of these uncertainties mean that the regulators, if they wish to game the benefit-cost analysis, can do so by assigning values to the benefits and costs that assure a net positive benefit. If the economists reject the result on the basis that the agency has failed to provide a reliable basis for estimating the benefits and costs, then virtually every benefit cost study on a serious policy issue should be rejected. There typically is no reliable basis for estimating benefits.

The harm of benefit-cost tests is often mitigated and redirected by politics

The Office of Management and Budget (OMB) economists who conduct the benefit-cost reviews generally cannot block the rules they review. The head of OMB is one of the most important members of the administration he serves and is expected to be a warrior for the administration. Politically, the OMB cannot regularly block the rules its administration supports. The administration appoints the heads of almost all the regulatory agencies, so the great bulk of rules the OMB's economists review are rules supported by the administration. In practice, then, even the OMB's theoclassical economists can rarely act as a “hanging jury” or “star chamber” and kill rules they despise. OMB economists are political beasts; they don't stay if they can't stand to approve programs. OMB economists know that benefit-cost analysis is theater. If the rule has the support of powerful administration officials OMB will not block it on the grounds that it fails to produce net benefits. OMB economists will work with the agency to game the benefit-cost analysis to ensure that it shows net benefits. Benefit-cost analysis becomes yet another bureaucratic hoop that adds cost and delay without providing benefits. OMB's benefit-cost analysts occasionally reject a rule on the grounds that it produces net costs, thereby “proving” that it saves the government money and “quantifying” those major savings. Of course, if the rejected rules' benefit-cost studies been slightly tweaked by the agency or OMB's economists the supposed benefits of benefit-cost studies would disappear.

The real function of OMB's benefit-cost analyses is to squash agency heads the administration does not trust – even if it appointed them. It's all about maximizing the administration's power over the agencies, particularly the “independent” regulatory agencies in order to minimize their independence – another undesirable feature of the selective use of benefit-cost analysis. If OMB had the power to block the Federal Home Loan Bank Board's reregulation of the savings and loan industry under the leadership of Chairman Gray it would have done so and the roughly 300 accounting control frauds would have continued to grow at 50% annually, which would have produced over a trillion dollars in losses. OMB, however, would have claimed that its benefit-cost analyses proved that it had saved millions of dollars by blocking our reregulation.

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Bill writes a column for Benzinga every Monday. His other academic articles, congressional testimony, and musings about the financial crisis can be found at his Social Science Research Network author page [3] and at the blog New Economic Perspectives [4].

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