POLICY SPOTLIGHT

How the Social Discount Rate Makes Regulatory Analysis Unsound

JAMES BROUGHEL | JUNE 2021

Cost-benefit analysis (CBA) has been adopted by the US federal government in the past several decades as the primary analytical tool to evaluate regulations and their effects on societal well-being. The use of CBA eventually spread beyond Washington, DC, as both states and governments internationally began to adopt it.

While potentially a useful tool to guide decision-making, CBA, as applied, suffers from significant shortcomings. By frequently ignoring or underweighting the actual consequences of government policy, CBA today has little connection to the evidence-based tool as it was originally conceived. Fortunately, the Biden administration plans to revisit the instructions it gives to federal agencies on how to produce regulatory analysis, including CBA. Shoring up CBA's problematic underpinnings should be a top priority, since the credibility of policy often rests on the credibility of the analysis that supports it.

DISCOUNTING THE FUTURE

One of the most important inputs into CBA is the *social discount rate*. In CBA, the social discount rate is the primary means of aggregating individual preferences so that they can be compared on a common social welfare scale. The following must be borne in mind when choosing the social discount rate:

- Selection of this rate involves value judgments about how much weight future health, well-being, and lives saved should receive in analysis.
- These value judgments take matters beyond the realm of objective fact that can be discovered through scientific exploration; as such, choosing this rate is likely beyond the competence and expertise of federal regulators.
- Policy guided by such value judgments is often no more than an expression of the preferences of regulators about their desired course of action.

MISSING BENEFITS AND COSTS

By adjusting costs and benefits using a more or less arbitrarily chosen social discount rate, an analysis no longer evaluates costs and benefits as they will actually occur. Compounding this problem, federal regulatory agencies routinely underweight important costs and benefits in their analyses, including returns associated with capital investments. This happens because the social discount rate and the rate of return on capital investments are consistently conflated in regulatory CBA, despite being two distinct concepts.

To correct these deficiencies, CBA should be grounded in a framework that reports costs and benefits as they are expected to occur, and it should account for the opportunity cost of investments that are created or displaced in the process of regulating separately from the issue of discounting the future.

KEY TAKEAWAY

At first glance, CBA looks scientific. Closer inspection reveals that it is better described as a way of expressing certain policy preferences, rather than as a tool to objectively report the tradeoffs society confronts each time a policy intervention is considered. It can be argued that even in its present problematic form, CBA at least forces regulators to explain their reasoning for programs and regulations that can cost billions of dollars. But given what's at stake, that is too low a bar. As the Biden administration considers how to improve the regulatory analysis and review process, addressing problematic practices relating to the social discount rate should be a top priority. This would pave the way for significant improvements in evidence-based policy.

FURTHER READING

James Broughel, "Cost-Benefit Analysis as a Failure to Learn from the Past," *The Journal of Private Enterprise* 35, no. 1 (2020): 105–13.

James Broughel, "The Unlikely Story of American Regulatory Socialism," *The Quarterly Journal of Austrian Economics* 24, no. 1 (Spring 2021): 147–65.

James Broughel, "The Social Discount Rate: A Primer for Policymakers" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, June 2020).

James Broughel, "What Is vs. What Should Be in Climate Policy: The Hidden Value Judgments Underlying the Social Cost of Carbon" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, April 2021).

James Broughel, "The Mighty Waves of Regulatory Reform: Regulatory Budgets and the Future of Cost-Benefit Analysis," *The Business, Entrepreneurship & Tax Law Review* 3, no. 2 (2019): Article 3.

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