

Review

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Benefit-Cost Analysis: A Political Economy Approach

by A. Allan Schmid

Boulder, CO: Westview Press, 1989, \$29.50, 354pp.

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This review consists of three parts, following in order from three questions: What is the book about? What are its strengths and weaknesses? For what type of course is it suited?

This book is a thorough, cogent, and well-balanced examination of a subject that too frequently receives an uncritical (and on occasion, cookbook) treatment. Schmid is critical, but constructively so. He points out both methodological and operational weaknesses of benefit-cost analysis (BCA) as currently practiced and argues that to ignore these shortcomings is to render the public policy process misinformed and misdirected. Schmid's call is for a broadening of the benefit-cost framework to encompass and thereby overcome current weaknesses. Above all, *Benefit-Cost Analysis* advocates abundant wise use of BCA, defined broadly as "an analytic framework for organizing thoughts, listing the pros and cons of alternatives, and determining values for all relevant factors so that the alternatives can be ranked" (p. 1).

By "pros and cons of alternatives" Schmid means all the pros, all the cons, and all the alternatives. As such, BCA would not be limited to benefits and costs for which market prices or proxies are available. (Schmid sees nothing sacrosanct about market measures of value, since market measures ultimately flow from the rights, rules, and regulations established by government.) Likewise, BCA would not be constrained by "non-economic" factors such as endangered species or wilderness designation. In Schmid's design, everything relevant to a proposed government action would be assigned a value, including endangered species, Native American rights, human life, and even future generations. Values would not be assigned by

economists, but would be produced with their help through the interaction of all the participants in the political process.

"In theory," Schmid would like to see a comprehensive systems analysis using program budgeting to assign values to all consequences and rank all public projects (broadly defined), but, due to unmanageable data and political problems, he instead advocates "limited systems analysis" employing segmented budgets. Limited systems analysis would segregate budgets (by agency, for example) with the process involving analyst and politician in addressing crucial value questions; in particular, "Whose interests are going to count?" and "How are the inseparable efficiency and distributional objectives going to be balanced?"

These value judgments are inescapable. It follows that for policy to be valid, decisions about whose interests are going to count must be made legitimately, which to Schmid involves open, informed discourse. We all know that an efficient economy will allocate resources differently under alternative initial distributions of resource claims. Unlike most economists, who assume the existing distribution of entitlements to be legitimate (thereby judging it so), Schmid observes that government action necessarily involves choosing between competing interests. Government is in the business of creating and destroying entitlements—of deciding whose interests are going to count for more, and whose for less. It is not a question of whether government *should* tamper with rights. It does, and it will continue, if for no other reason than a changing world forces it to do so. Changes in technology, in the environment, and in social norms (regarding fairness, for example) force government to create and alter entitle-

ments. It is these choices that, to Schmid, compose the nucleus of public choice. Now I ask you, who are the better empiricists? The economists who assume a legitimate and unchanging set of entitlements and purport to pass judgment only on a project's efficiency, or the Al Schmid of our profession who insist on integrating the ongoing transformation of rights into their analysis?

In practice, efficiency and distributional objectives cannot be separated, so debate about tradeoffs between them should also be part of the policy process. Otherwise a project with distributional objectives (tobacco subsidies) may work directly against a project with efficiency objectives (health care resource savings and higher labor productivity).

Any and all criteria of project evaluation require value judgments. Schmid therefore rejects the "impartial expert" role for the economist, arguing that in our second-best world this approach tends to substitute the value judgments of the analyst for those of the elected participants in the political process. This leads him to consider the desires of politicians, who may prefer to leave values unclarified and comparative (policy option) information uncollected and unpublished. Schmid recognizes that production of, control over, and access to information in the political process is a source of power not only because information is a valuable resource, but also because additional information will inevitably alter values and priorities. Such inquiry is what Schmid means by his subtitle, "a political economy approach." His political economy is neither justification for nor blanket rejection of the status quo, but is rather a constructive, reform-oriented analysis, rooted in the reality of a political process wherein, inescapably, all sorts of rights are created and destroyed on a nearly continuous basis.

In short, Schmid's *Benefit-Cost Analysis: A Political Economy Approach* is balanced on two fronts: in identifying and assessing BCA's strengths and weaknesses, potentialities and limitations; also, in analyzing BCA's public policy context and its derivative political content. Over and over again Schmid stresses that project evalua-

tion is inseparable from, and therefore both limited and value-impregnated by, political decision making.

Contrary to the view of the economist as the detached, impartial expert who delivers the requested net-present-value-of-benefits calculation when called upon, Schmid would fully involve the economist (and, presumably, other social scientists) in the policy process. His text is "built on the premise that good analysis will facilitate widespread, informed public participation in decision making" (p. 3). The issue of whose interests are to count leads to the question of how this issue is decided, and Schmid believes a systematic approach that involves all concerned parties in the policy-making process can lead to more rational and consistent, and therefore less wasteful, policy. Open, informed involvement of individual citizens and interest groups as well as politicians and analysts would not only bring crucial value questions to the fore, it would also facilitate consideration of tradeoffs that are now ignored. This is the systems approach Schmid brings to the political economy of BCA.

Turning now to strengths and weaknesses, Schmid's book is, all in all, extremely good. His political economy is simply excellent. It is an empirical, holistic approach to inquiry that is "positive" in the sense that it describes reality with a minimum of implicit value judgments, instead driving home the point that conflicting interests and values are an inherent part of the policy process. To ignore that fact is to endorse existing arrangements, because politicians are not about to (nor should they) turn over budgetary, regulatory, and rule-making authority to economists' efficiency calculations. Existing arrangements include thousands of hidden, ill-informed, and unrecognized value judgments that trade off different interests, different objectives, different goods, and often end up working at cross purposes or against widely held objectives.

Schmid's agenda is to reform BCA by integrating it with the policy process, for the purpose of lending greater rationality to government activities. In making his case,

he has written a most thoughtful text on BCA that is crammed full of useful information and insight, and that incorporates from the literature a broad spectrum of opinion on most BCA topics.

The book's weaknesses fall into two general classes that I call pedagogical and philosophical, addressed in order. (The philosophical issues might be more accurately described as disagreements, and many readers of this review will find themselves disagreeing with me and agreeing with Schmid.) Economists would more easily follow the arguments if Schmid made it clearer at the outset that his use of the terms "political economy" and "public choice" are generic; that is, they do not refer to specific doctrine or school of thought. Non-economists would benefit from more even treatment of technical economic terms, which are usually, but not always, defined and explained clearly. For example, in chapter two Schmid uses "marginal rate of substitution" and "shadow prices" without defining them. This problem reappears in chapters five and seven. Treatment of technical issues is also somewhat uneven, almost as if different chapters were written with a different level of student training in mind. In chapter seven, the discussion of compensating and equivalent variation is overly complex and lengthy. Finally, although the thorough treatment of the literature is a big plus in this book, Schmid often spends several paragraphs summarizing the arguments of various authors without making his own position clear.

Turning to the philosophical and logical weaknesses, I find inconsistency in Schmid's assessment of the validity of market prices as measures of value. He questions the legitimacy of a rights regime that produces market prices on the grounds that those rights apparently have not been confirmed in the political process. Yet he does not question the legitimacy of market prices as a measure of value. He appears over and over again to embrace market values, yet states, "Prices emerging from market bargaining are no more real and legitimate than exchange ratios emerging from political bar-

gaining" (p. 280). I find this apparent inconsistency most troubling in his discussion of discounting (chapter nine), where for the first twenty pages individual time preference, as aggregated and translated by perfectly competitive capital markets into a market interest rate, appears sacrosanct. But later in the chapter Schmid raises questions of individual versus collective choice and intergenerational equity, and makes the point that if a future generation owns a resource, we have no business discounting it. Then he concludes, "I unequivocally side with those who regard [the discount rate] as a matter of public choice, not something to be discovered as prior datum. . . . The issue is not only one of political price versus market price but one of choice of whose market opportunities count." (p. 229).

Schmid's problem is that, lacking any semblance of a rational system of government policy, *all* measures of value are suspect. Yet one has to start somewhere, which means one has to use available information. Generally, market information is probably of better quality than government information, and if the rights regime that underlie the market is perverse, maybe the voters will figure that out and elect new representatives. But with mounting evidence that industrial era activities have been shifting massive costs onto future generations, we should abandon all illusions that the market produces useful information for long-run time preference decisions.

A more general problem is whether rational government policy-making is even possible. If society holds dear several fundamental but mutually inconsistent values, transitivity between these values simply cannot be established. The abortion issue is a case in point. Open, informed debate might help diffuse hostilities between groups that champion different core values, but it also might lead to destructive conflict. Society may have to continue to lurch to the defense of whatever core value appears most threatened; that is, irrational public policy may be inescapable.

Finally, Schmid's proposal to use systems analysis and program budgeting to integrate BCA with the political process

would assign prices to virtually everything. My objection is not that some things are priceless: we implicitly price human life when we engineer highways and regulate drugs, and we would do it far more sensibly under Schmid's reforms than we do now. But just as we cannot discount what we do not own, we likewise cannot price what we do not own. Before owners can be involved in bargaining, they have to be granted entitlements and an institutional mechanism to give them force. And for some resources, such as the earth's life-support system, no "owners" can or should be identified.

Pricing everything also denies a value hierarchy; that is, no values have priority over others (except by greater willingness to pay). A rising (revamped) GNP indicates unqualified improvement. Individual tastes and preferences, however shortsighted, manipulated, or ignorant, are all we have to guide resource allocation, whether through the market or the political process. This approach, while apparently serving us well, in fact began long ago to damage the future by shifting costs forward. We have developed sufficient power to disturb the earth's "tendency toward equilibrium" in ways about which we are only beginning to understand, with delayed pipeline effects.

I think Aldo Leopold was right when he speculated that human survival may ultimately depend on granting existence rights to all elements of the land community. To fit this program into Schmid's model we would have to devise institutions to give trees, salamanders, turtles, and future generations some real bargaining power. Alternatively, we can constrain our wealth-creating activities with inalienability rules, thereby acknowledging that GNP-type constructs are inherently incomplete measures of welfare. Schmid says the Endangered Species Act "assumes that the owners of the opportunity to enjoy snail darters . . . would reject any offer of money in exchange for their resource" (p. 168). I think not. The Endangered Species Act flatly denies any and all rights of species ownership, which in turn prohibits bargaining by buyers and sellers to establish a price. A century and a quarter ago we de-

nied ownership of human beings, and we are now denying ownership of any living species. Leopold believed our evolutionary success hinged on such extensions of rights.

BCA is rooted in the Newtonian neoclassical model, which is atomistic, isomorphic, and reductionist. This is an inappropriate basis for sustainable development policy because our world does not exhibit any of these characteristics. *Of course* it makes sense to attempt to assess all the pros and cons of alternatives, but to do this in today's world requires that we employ co-evolutionary ecological systems models.

Turning to the suitability of Schmid's book as a text, first note that I believe students should learn to think critically while they acquire both technical competence and an appreciation of the limitations as well as the strengths of an approach or tool. In hoping to accomplish these goals, I usually assign the majority of two or three texts, or assemble a collection of readings. Schmid eliminates the need for multiple texts, and he reduces substantially the number of supplemental readings needed for a well-balanced course. For graduate economics courses in BCA, supplemental materials addressing all sorts of details will of course be necessary, depending on specific course objectives.

For some economists, the book has a major drawback as a text. Because of its empirical grounding in how policy is made and its goal to inform and reform that process, Schmid's text will not be as easy to teach from as traditional BCA texts. Schmid covers the "straight and narrow" benefit-cost research program, and cites a vast, and to my knowledge, comprehensive literature, but, at each and every turn, goes on to examine not just the assumptions behind the program, but the implications of relaxing those assumptions. Schmid is unwilling to treat the policy process as separate from analysis, and is unwilling to treat the question of whose interests are to count (and for how much) as prior data. This is methodological holism, and more importantly, it is the best kind of empiricism.

Schmid's unwillingness to adopt distort-

ing assumptions in order to achieve a straightforward, logical, and "compelling" case for the adoption of BCA as a decision rule makes this text more relevant than traditional BCA texts, especially for students of political science and public policy. Although few economists advocate BCA as *the* decision rule, most texts promote narrow efficiency measures based on "natural" and therefore presumably legitimate market (proxy) measures. Such texts are easy to teach from, and convert students to "the economic way of thinking," and are fine for academic imperialists, who will continue to use them. (Un)fortunately, they contribute little to actual policy-making.

Schmid's *Benefit-Cost Analysis* sets a high standard for authors who aspire to empirical accuracy, scholarly thoroughness, and intellectual honesty. His prose is guided not by the goal of winning converts to a particular economic doctrine, but by the goals of analyzing the actual milieu in which BCA is practiced, and contributing to reform of both the analytic framework

and the policy process. This is a difficult task, but Schmid is up to it. For balance, impartiality, thoroughness, and constructive policy content, A. Allan Schmid's *Benefit-Cost Analysis* sets a high standard indeed. By so doing, it promotes policy-relevant, empirically-based economic analysis and open, reasoned consideration of the consequences of proposed alternative policies. Schmid's book is must reading for concerned professionals, be they academics, consultants, congressional staff, or agency personnel. Although its major themes and key chapters are within easy reach of advanced undergraduates, *Benefit-Cost Analysis: A Political Economy Approach* will be widely adopted as a graduate text in political science, public policy, and economics.

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