The Ethics of Cost Benefit Analysis

BY D. GRANT VINGOE

Two recent books have taken very different approaches to the influence of market economics on government and society. *Simpler: The Future of Government by Cass Sunstein*, the former Administrator of the Obama Administration's White House Office of Information and Regulatory Affairs, (the U.S. "Regulatory Czar"), analyzes how regulatory goals can be achieved through the right 'choice architecture', through better designed "nudges" to promote individual and corporate behaviour to further social goals. What *Money Can't Buy: The Moral Limits of Markets* by Michael Sandel, a Professor in the Harvard University School of Government, critiques how market economics has increasingly dominated social relations, with market induced 'bribery' and 'corruption' replacing behaviors rooted in moral values. Bribery has the usual meaning of paying off someone to engage in sought-after behaviors. Sandel describes "Corruption" as follows:

We often associate corruption with ill-gotten gains. But corruption refers to more than bribes and illicit payments. To corrupt a good or a social practice is to degrade it, to treat it according to a lower mode of valuation than is appropriate to it.

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Sunstein is concerned not only with the choices made by citizens, but also nudges to governmental agencies to promote the best regulatory results. 'Best' for this purpose requires a process encapsulated by a U.S. Presidential Executive order, requiring that each agency, among other conditions:

1 propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify);

2 tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;...

Sunstein uses the term "Regulatory Moneyball" in an unequivocably favorable manner to promote evidence-based regulation that protects against irrational impulses consistent with this Order:

It subjects fears and concerns to a kind of technocratic scrutiny to ensure that the demand for a regulatory response is rooted in reality rather than rumor and myth...

Although cost-benefit analysis is paramount, Sunstein is willing to take into account values-based factors in the interests of equity. For example, a safety regulation benefiting workers making luxury goods, or requiring rear view cameras in new cars to reduce child fatalities are passed even if the benefits (financially measured) are limited or absent. However, these value-based decisions are the exceptions to a norm of quantitative analysis.

Sandel focuses on the trend of the private sector imposing commercial values in areas touching social values: education, healthcare, the market for insurance products, the role of sports in society, but government is not unscathed. Sandel quotes his then Harvard colleague, Larry Summers, in 2004 as saying that Moneyball was illustrative of an "important intellectual revolution that has taken place in the last 30 or 40 years": the rise of social science, and specially economics, ("as an actual form of science").

Sandel continues with his analysis, quoting Summers in part:

Where else in Summers' view, was the wisdom of the scientific Moneyball approach coming to prevail? In the hold of environmental regulation, where "committed activists and attorneys" were giving way to "people who were skilled in performing cost-benefit analyses". In presidential campaigns, where the bright young lawyers who predominated in the past were now less needed than "bright economists and bright MBAs", and on Wall Street, where computer-savvy, quantitative whizzers were displacing schmoozers and inventing complex new derivatives..."

The irony in Sandel's quotation of Summers is acute, as is the discomfort for any reader who shared this confidence in social science-based decision-making.

In the examples of market approaches crowding out moral values, Sandel's case is built on examples in varied fields that draw an emotional, values-laden reaction, - 'System 1' in Sunstein's vocabulary, the automatic system, as opposed to System 2, the more deliberative and reflective system of decision-making at the root of cost-benefit analysis.

Financial regulation is an area where it is regularly asserted that cost-benefit analysis should prevail since outcomes are measured in financial terms: efficiency in the capital raising process and investment returns. However, it is worth considering whether moral values are at risk of being crowded out by a fixation on cost-benefit analysis in this area as well.

A classic case in which cost-benefit analysis is not entirely at the root of a fundamental securities regulation is insider trading. There is a general social consensus that it is unfair for someone in possession of material non-public information, at least when used by or obtained from someone with a duty to maintain a confidence, to trade based upon such information. This consensus holds even if the trading activity results in more efficient pricing of securities by having the insider trading pricing signals entering the market-place earlier. There are costs associated with insider trading, such as premature loss of proprietary information to competitors, or greater difficulty in effecting a merger, but the System 1 response is an outraged reaction that this conduct is just wrong.

A more nuanced discomfort arises with 'expert networks', in which academics, corporate officers and even government officials, provide exclusive 'colour' to professional investors for a fee. Many question the ethical standing of at least the extreme forms of this practice without regard to cost-benefit analysis. Is this System 1 objection misplaced?

High frequency trading provides a rich source of examples to pose this question. Should a stock exchange whose licensed status arises because of the public objectives of facilitating capital formation and investment, be permitted to allow some investors to trade more rapidly through co-location of trading servers or provide such investors with quotes for a brief interval before other investors? Should Exchanges permit high frequency traders to design order types tailor-made to provide them with an edge over less sophisticated investors?

Should intermediaries have unlimited discretion to offer house products for which conflicts of interest exist without affording alternatives? Instead, should intermediaries be additionally required to encourage retail investors to invest in low cost, basic financial products, with equivalent performance, for which conflicts of interest are limited or non-existent?

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These are all areas in which cost-benefit analysis can yield verifiable results that could point to these practices being innocuous. However, in the aftermath of the financial crisis, when life savings were impaired and a pension benefit crisis looms, these are moral issues as well. Public investors should be regarded as a protected class for which equitable considerations balance in their favor. This does not mean that the cumulative costs of regulation should not be taken into account. We need financially healthy, customer-oriented intermediaries to help firms raise capital and investors to build investments and savings, but the duty to public investors must be paramount.

There are two other concerns with a strict adherence to cost-benefit analysis. First, regulators may well give more weight to quantitative analysis provided by the industries that they regulate. Commercial interests affected by regulation directly, or through trade associations, can commission studies to support their cause. It is very difficult for public investors to come together to provide a counter-weight. Academic studies may do so, as well as organizations such as the Foundation for the Advancement of Investor Rights, which has made valuable contributions in Canada. These counter-weights are not consistently available and will likely never be as well funded as industry. Regulators can assume this burden, but cannot fully act as both an advocate as well as decision-maker.

Here the answer lies in both an openness to equitable arguments, equal to the weight given to cost-benefit analysis, regarded as an ethical imperative for the benefit of public investors.

The second difficulty, when cost-benefit analysis is a condition for the adoption of a rule, is the growing trend in the United States for industry trade associations to sue agencies based on allegations that the cost-benefit analysis is flawed. Again, industry can mount these challenges in a manner that investors cannot. This litigation generates delay and substantial costs in the regulatory process. Efforts should be made to expedite legal challenges and to incorporate broader public interest considerations.

This litigation trend has not entered Canada yet since provincial securities laws embody a broader concept of the public interest in rule-making. The U.S. litigation experience provides a warning about going too far in Moneyball regulation.

Cost-benefit analysis can be a very useful tool in assessing regulations, but it can be a corrupting influence, in the sense used by Sandel, if it becomes primary definition of the public interest, squeezing out the ethical dimension of public policy.

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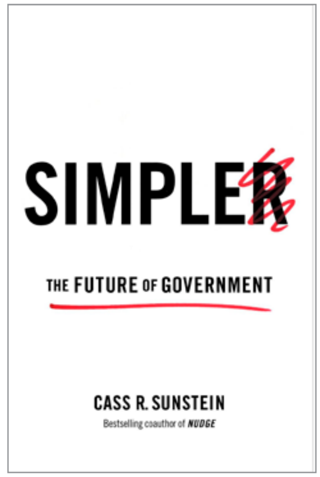

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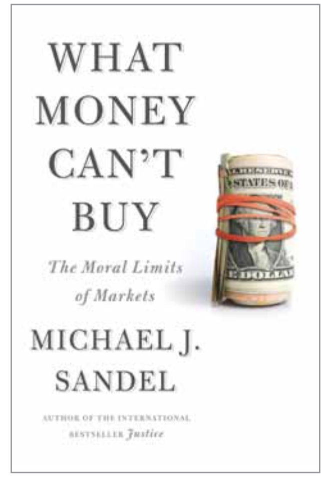

WHAT MONEY CAN'T BUY: THE MORALS OF MARKETS BY MICHAEL J. SANDEL

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