The Planner's Paradox

By Brian Mannix

Along with its *2003 Report to Congress on the Costs and Benefits of Federal Regulation,* the Office of Management and Budget recently released a new draft Circular containing guidelines to be used by regulatory agencies in preparing Regulatory Impact Analyses. For two years, the Bush administration had relied on economic analysis guidelines issued under President Bill Clinton. (See "Mercatus Reports," Spring 2003.) The Bush draft has surprised many observers because it appears to impose less discipline, rather than more, on the practices of federal agencies.

One notable example is the relaxation of the threshold determination that federal intervention is justified. Under the old guidelines, before embarking on a benefit-cost analysis of regulatory options, an agency had to explain the market failure that it proposed to remedy and why a federal solution was needed. The new guidelines permit weaker rationales such as that the regulatory action meets some "compelling public need such as improving governmental processes or promoting distributional fairness, privacy, or personal freedom." And agencies can justify a strong federal role simply by citing the need for "harmonization" of rules.

Benefit-cost analysis Instead of demanding a cogent reason for federal intervention, the new draft guidelines place greater reliance on benefit-cost analysis (or even cost-effectiveness analysis) to justify a regulation. The draft tells agencies, "You should show that a government intervention is likely to do more good than harm." Of course, benefit-cost analysis has a checkered history — much of it written by the Army Corps of Engineers where the practice originated in response to the Rivers and Harbors Act of 1900.

Even when it is done carefully, benefit-cost analysis suffers from a serious theoretical flaw well known to economists: It presumes that the analyst can make interpersonal comparisons of individual welfare, concluding in effect that the "winners" in any given project would be willing to compensate the "losers" (even if no actual compensation is ever paid). This takes benefit-cost analysis outside the realm of positive (observational, descriptive, scientific) economics and into the sausage-factory of policymaking.

Nonetheless, benefit-cost analysis has become the accepted, objective standard for judging both spending programs and regulatory programs. It is perennially a subject of rhetorical ridicule, but has been required by every president since Richard Nixon. Indeed, no good substitutes are available for evaluating the wide range of policy decisions that Congress delegates to federal agencies.

Unforeseen costs What the draft OMB guidelines fail to recognize is that, while a favorable benefit-cost analysis should be considered a necessary condition for approving a regulatory intervention, it should never be considered sufficient. One reason is that such analyses suffer from an inherent bias that I call the Planner's Paradox — the tendency of planned solutions to appear superior to unplanned market solutions in any economic forecasting model or benefit-cost analysis.

This bias is not simply the result of the well-known tendency of agencies to fudge their analyses — to write a regulation and then order up an analysis to support it. A perfectly honest and conscientious agency would first write the analysis and then choose the option that maximizes net benefits. In both cases, however, you end up with a regulation and an analysis that are "tailored" to each other. And in both cases, the results of the analysis will portray the agency's plan in too favorable a light.

Agencies tend to make planned solutions appear superior to unplanned market solutions in any model or analysis.

The reason for this is that both the plan (the proposed regulation) and the supporting analysis are prepared with the same set of data, assumptions, biases, and understandings of the way the world works. Indeed, if the planned solution is designed to "fix" problems identified in the analysis, then the analysis will necessarily make the plan look better than the "unfixed" alternative in every dimension examined by the analyst. All of the unseen difficulties with the planned solution — the data, assumptions, biases, and understandings of the world that turn out to be wrong — are invisible to the analyst because the data he considers are his own.

"Optimal" results An example of the Planner's Paradox (and the case that caused me to coin the term) is the analysis of appliance efficiency standards issued by the Department of Energy beginning in 1979. The analysis supporting the standards filled several feet of bookshelf space and there were innumerable points at which to criticize the data and the methodology. But it quickly became clear that, no matter how many corrections one might make to the analysis, it would still support mandatory efficiency standards. That is because the DOE had calculated what the "optimum" appliance would look like, and adopted that as the standard. (One could hardly expect a responsible planner to do anything else!) The DOE then collected data on the appliances

Brian Mannix is a senior research fellow at the Mercatus Center at George Mason University. He can be contacted by e-mail at bmannix@gmu.edu.

KEVIN TUMA

that consumers actually buy. To the extent there was any difference, consumers must be buying "suboptimal" appliances. Mandatory standards would therefore have positive net benefits by forcing consumers to make the optimal choice. That result was "hard-wired" into the model.

What is striking about this methodology (and what sets it apart from positive economics) is that the analyst attributes any difference between his prediction of what the market should do and what it actually does to errors on the part of the market, not to errors on the part of the analyst. Even without any plausible market failure, the benefit-cost analysis of the appliance standards appeared to demonstrate that the DOE knows what is best for consumers. The underlying reason was that, simply by undertaking such an analysis, the Department assumed it knew what is best. In fact, however, the government was simply substituting its own preferences for consumers' preferences. We know that this should produce negative net benefits (because consumers are the best judges of their own welfare), but the analysis showed otherwise because it is so difficult for an agency to separate its economic analysis from its own policy choices.

More recently, the Energy Department has recognized the inherent limitations of policy analysis. In its recent report to Congress, *Impact of the Federal Energy Regulatory Commission's Proposal for Standard Market Design*, the Department includes the following enlightened disclaimer:

> Regulators and policymakers fashion policy proposals to address particular problems. Both their characterization of the problems and their expectations about the effectiveness of the proposed solutions are unavoidably affected by a network of assumptions and by information limitations. The "planner's paradox" is the difficulty of being adequately prepared for "unknown unknowns."

The Planner's Paradox is related to the Winner's Curse, a well-known affliction of offshore oil leases and other auctions. Prior to an oil lease auction, bidders have only a limited data set and will likely make widely varying estimates of the value of any particular tract. By awarding each tract to the highest bidder, the government is also awarding each tract to the company that is most likely to have erred on the high side in estimating the tract's value. As a result, every winner is likely to lose money on its leases; hence, the Winner's Curse. But markets correct for this problem. Sophisticated bidders learn to discount their own analysis to correct for the effect of the Winner's Curse; unsophisticated bidders eventually disappear. In government regulation, however, no such correction ever takes place. Because of the Planner's Paradox, agencies continue to make regulatory decisions that reflect overly optimistic assumptions about their own ability to forecast the future.

For this reason, the OMB's guidance needs to stress the comparative analysis of market failure and regulatory failure, and not simply rely on the results of benefit-cost analysis to justify regulatory interventions. And the OMB, in its general guidance and in its review of regulatory analyses, should make efforts to penetrate false assurances that are inherent in the planner's analysis of his own plan. R