

# Does the Social Cost of Carbon Matter? Evidence from US Policy

Robert W. Hahn and Robert A. Ritz

## ABSTRACT

We evaluate a recent US initiative to include the social cost of carbon (SCC) in regulatory decisions. To our knowledge, this paper provides the first systematic analysis of the extent to which applying the SCC has affected national policy. We examine all economically significant federal regulations since 2008 and obtain an unexpected result: putting a value on changes in carbon dioxide emissions does not generally affect the ranking of the preferred policy compared with the status quo. Overall, we find little evidence that using the SCC has mattered for the choice of policy in the United States. This is true even for policies explicitly aimed at reducing carbon dioxide emissions. We offer some possible explanations for the patterns observed in the data.

## 1. INTRODUCTION

Economists have long supported policies that incentivize individuals and organizations to consider the full costs of their actions as they affect society (Coase 1960). This is particularly true where there may be large divergences between private and social costs, as is the case with many environmental problems. Almost a century ago, Pigou (1920) argued that

ROBERT W. HAHN is Professor and Director of Economics at the Smith School of Enterprise and the Environment at University of Oxford, Senior Fellow at the Institute for New Economic Thinking at the Oxford Martin School, nonresident Senior Fellow at the Brookings Institution, and Senior Fellow at the Center for Business and Public Policy at Georgetown University. ROBERT A. RITZ is University Lecturer in Economics at University of Cambridge and Research Associate at Energy Policy Research Group. We gratefully acknowledge the excellent research assistance of Sarah Ridout and Kevin Soter. We would also like to thank David Frame, Michael Greenstone, William Hubbard, Elizabeth Kopits, Albert McGartland, Michael Pollitt, Paul Watkiss, and two anonymous referees for very helpful comments. This research was supported by the Smith School at University of Oxford and the Global Governance Programme at the European University Institute. The authors alone are responsible for the views expressed in this paper.

[*Journal of Legal Studies*, vol. 44 (January 2015)]

© 2015 by The University of Chicago. All rights reserved. 0047-2530/2015/4401-0007\$10.00

one way to appropriately incentivize economic agents to consider the full costs of their actions is to impose taxes on activities that fully reflect their marginal damages to society.

In the case of climate change, a growing number of economists have argued for introducing market-based mechanisms, such as taxes or cap-and-trade systems, as ways of limiting greenhouse gas emissions (Anthoff et al. 2011a; Metcalf and Weisbach 2009; Stavins 2007). These mechanisms have been tried in various places, notably Europe, with varying degrees of success (Ellerman and Buchner 2007).

Absent an economy-wide incentive scheme, governments can account for greenhouse gas emissions by adding to benefit-cost analyses a measure of the marginal damages from climate change. Economists have argued that such environmental damages should be explicitly included in benefit-cost analysis to the extent that they can be quantified (Arrow et al. 1996). For example, a government might consider a regulation to increase fuel economy standards for automobiles and include the reduction in carbon dioxide (CO<sub>2</sub>) emissions as an additional benefit that has a monetary value.

To perform such an analysis, that government would need to attach a value to a metric ton of reductions in CO<sub>2</sub> emissions. One such value is the social cost of carbon (SCC), which measures the monetized damages associated with emitting a specified quantity of CO<sub>2</sub> emissions into the atmosphere (Nordhaus and Boyer 2000). There has been much work on the appropriate value of the SCC (Tol 2009; Anthoff et al. 2011b; Greenstone, Kopits, and Wolverton 2013). For example, Greenstone, Kopits, and Wolverton (2013) note that the US government used a central estimate of \$21 per metric ton (in 2007 dollars) for global damages resulting from CO<sub>2</sub> emissions in 2010.<sup>1</sup>

While there has been much debate about the appropriate value of the SCC, there has been much less research on the actual use of the SCC in the design of policy. Watkiss and Downing (2008) examine the use of the SCC in UK policy, while Watkiss and Hope (2011) examine more broadly how the SCC is used in regulatory deliberations. Watkiss and Hope (2011) note that several countries use a global SCC, which incorporates damages for global carbon emissions for different regulatory activities; examples include the United States, the United Kingdom, the

1. A more recent update by the US government argues that the social cost of carbon (SCC) in regulatory analysis should be at least 50 percent higher than initial estimates (Interagency Working Group on the Social Cost of Carbon 2013). These new values for the SCC are used in analyses of regulations beginning in 2013.

Netherlands, Finland, and Italy.<sup>2</sup> They offer a number of interesting insights regarding the SCC, including how its value has changed over time, the importance of SCC values in different sectors, trade-offs in using ranges and point estimates for the SCC, and examples in which the use of the SCC appears to have changed the results of a particular benefit-cost analysis. Kopp and Mignone (2012) examine several US rules with energy efficiency standards and offer suggestions for improving the application of the SCC to regulatory policy. The analysis to date has been largely based on examples rather than an exhaustive review of all regulations or policies. Existing studies are not designed to test the overall impact of using the SCC on a nation's policy choices. Our paper seeks to fill this gap in the literature.

This paper examines the role of the SCC in US federal regulatory policy. To our knowledge, it provides the first systematic analysis of the extent to which applying the SCC has affected national policy. Our sample includes the entire set of significant federal regulations that consider the SCC in the United States, beginning in 2008, when this policy was first implemented. These regulations typically have an annual economic impact of at least \$100 million.<sup>3</sup>

To assess how outcomes were affected, we examine estimates of net benefit provided by the US government for all significant federal regulatory policies from 2008 through 2013. We consider 53 regulatory policies, with and without including estimates of the benefits associated with changes in CO<sub>2</sub> emissions. Over half of the policies that we consider set energy conservation standards for commercial or residential items, such as electric motors or dishwashers. Most of the remaining policies set lim-

2. Whether countries should use a global SCC is an open question. With the exception of climate policy, most US regulatory policy focuses on the impact on US citizens. Perhaps this is because most US regulations primarily affect the country's citizens. Still, other policy arenas in the United States that affect the welfare of citizens in other countries—such as defense, trade, and monetary policy—appear to be guided primarily by an assessment of the costs to and benefits for US citizens. Thus, it is not obvious why climate change should be treated differently. See Gayer and Viscusi (2014) for a recent analysis of this issue in the context of US climate policy. For a formal economic model of why using the global cost of carbon is almost never optimal, see Hahn and Ritz (2014). For an ethical defense that is sympathetic to its use, see Broome (2012).

3. We use the term “economically significant federal regulation” to denote a “significant regulatory action,” as defined by Executive Order No. 12,866 (3 C.F.R. 638, 641 [1994]). This definition includes actions that may result in a rule that has “an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities.”

its on hazardous pollutants from large entities, such as petroleum refineries or electric utilities.

We examine whether inclusion of the benefits from reductions in CO<sub>2</sub> emissions changes the sign of the net benefits for each regulatory policy. We find that the SCC was used in many rule makings. We also find that, for some rule making, the benefits from reducing CO<sub>2</sub> emissions represent a significant fraction of total net benefits for the policy that was selected. However, we find that the impact of including the SCC on regulatory policy appears to have been limited. This finding holds for a wide range of regulations, including those rules that were explicitly motivated by climate change considerations.

We obtain the result that including the benefits from estimated changes in CO<sub>2</sub> emissions does not generally change the sign of quantified net benefits relative to the status quo. Put differently, in almost all cases, government estimates of net benefits are positive both with and without the SCC. This finding provides support for the view that the SCC has not had a big effect on US policy to date.

We then consider whether the SCC changes the ranking of different policy alternatives within a given regulatory policy based on their expected net benefits. In other words, has the SCC led to changes in the details of a regulatory policy? We find some evidence that it does change the economic rankings of alternatives in a small number of cases. Whether this led to a change in the actual regulatory decision is less clear because, as we discuss below, there are many factors that go into such a decision, not simply the expected net benefits of the policy.

On the basis of this evidence and our analysis, we argue that the SCC does not appear to have had a substantial impact on US policy between 2008, when it was first used, and the beginning of 2013. We consider explanations for our finding related to the political economy of regulation. We also suggest how the government's approach to benefit-cost analysis could be modified to increase the expected net benefits associated with regulation.

This paper proceeds as follows. Section 2 presents the analytical approach, and Section 3 presents the main results. Section 4 concludes and suggests areas for future research.

## 2. EMPIRICAL METHODOLOGY

We begin by discussing the different ways in which incorporating the SCC could affect regulatory decision making and the extent to which

these can be measured empirically. In general, the introduction of the SCC could affect the regulations that are considered, the alternatives that are considered in designing a regulation, the ranking of those alternatives based on estimates of net benefits (that is, the difference between benefits and costs), and the choice of a particular regulatory policy by the agency.

We cannot observe the regulations under consideration but do not believe that introducing the SCC has had much, if any, impact on these regulations. The reason is that the regulations under consideration are generally determined by laws or court decisions that require agencies to take a regulatory action. We also cannot observe whether the specific policy alternatives considered in a regulation were affected by the introduction of the SCC, but we were unable to find discussions in regulations suggesting that this factor was prominent.

However, we can observe how the SCC affected the ranking of alternatives based on net benefits for a number of regulatory policies, and we can also observe the choice of a particular regulatory policy. We discuss our approach to obtaining and analyzing these data in detail below.

Our methodological approach for assessing the impact of the SCC relies on benefit-cost analyses prepared by regulatory agencies in the United States (Hahn and Tetlock 2008). The United States requires selected regulatory agencies to assess benefits and costs for all significant federal regulations and, to the extent possible, “propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs” (Exec. Order No. 12,866, 3 C.F.R. 638, 639 [1994]).

The search algorithm for identifying specific benefit-cost analyses involved three steps. First, we identified the set of rules in our main sample by searching for rules that included a discussion of the SCC. Second, we identified benefit-cost analyses in those rules that permitted a comparison of the policy choice made by the government with the status quo. Third, we identified benefit-cost analyses in those rules that allowed us to examine whether the relative ranking of policy alternatives changes with the inclusion of benefits from reductions in CO<sub>2</sub>.

To identify rules in the main sample, we searched the US Federal Register (which lists all regulations) for rules containing the phrase “social cost of carbon” or “social cost of CO<sub>2</sub>.” We searched for proposed and final rules.<sup>4</sup> We then searched the Web site Regulations.gov (which con-

4. A proposed rule is a regulation that the government has proposed but has not received final approval from the executive branch. A final rule is a regulation that the government has finalized and is scheduled to be implemented.

tains all supporting material for regulations) for documents that contain the same phrases.<sup>5</sup> When we found documents that corresponded to rules not found in the Federal Register, we added the rules associated with these documents to our sample.

We included proposed rules in our main sample only when final rules had not been issued, because proposed rules are usually very similar to final rules. We found rules from three regulatory agencies: the Environmental Protection Agency (EPA), the Department of Energy (DOE), and the Department of Transportation (DOT).

We searched all rules for complete benefit-cost information, with and without the economic benefits of changes in CO<sub>2</sub> emissions included. We found 23 proposed and 29 final rules between May 2008 and April 2013 that provided an estimate of quantified benefits and costs for the policy selected by the agency.<sup>6</sup> Sixteen proposed rules were associated with final rules. We did not include the analyses from these proposed rules in our main sample because, in most cases, they were very similar to the analyses in the final rule. This left a total of 36 rules ( $[29 + 23] - 16$ ) in our main sample. While we did not include the matching proposed rules in this sample, we did check these proposed rules to ensure that they are consistent with the findings presented below. We report these results in a sensitivity analysis.

Our main analysis compares the net benefits of the policy selected with the status quo. Since rules often contained multiple benefit-cost estimates for a given policy, we developed a procedure for choosing among them. We have retained a fuller record of our work in an Excel spreadsheet, which is available upon request. The spreadsheet contains a complete list of the rules that we reviewed and explanations of our judgments about what to include.

We identified benefit-cost analyses at the highest level of aggregation for which the agency provided sufficient information on net benefits. We chose the highest level of aggregation to be conservative regarding the size of the sample. For example, we recorded fuel economy standards for

5. US Government, Regulations.gov (<http://www.regulations.gov/#!home>).

6. We found one rule with no net benefits. The Environmental Protection Agency (EPA) asserted that owners of electricity-generating units would meet certain greenhouse gas emissions standards even in the rule's absence, so the rule would not affect their behavior. We do not include this rule in our sample. We also found five final rules that provided incomplete information on costs and benefits. In one case, the Department of Transportation (DOT) was unable to estimate net benefits; in two others, the Department of Education (DOE) chose not to estimate net benefits for the policy that it selected because it had eliminated all other legally permissible alternatives. In the final two cases, the EPA and DOT did not discount net benefits at 3 percent.

heavy-duty vehicles as a single observation rather than recording separate observations for pickup trucks and vans, vocational vehicles, and tractors. This approach yielded a total of 53 benefit-cost analyses, which are summarized in Table A1 in the online appendix.

The next step in our analysis was to compare the net benefits of selected and rejected policy alternatives to assess the impact of including benefits of reductions in CO<sub>2</sub> emissions on the ranking of policy alternatives. We first identified regulatory policies that quantified net benefits for at least two policy alternatives. In choosing particular benefit-cost analyses, we continued to follow the procedures described above. For example, we chose the benefit-cost analyses at the highest level of aggregation provided by the agency. This approach yielded a total of 202 policy alternatives for 43 policies.

We took all the information on benefits and costs in the rules as given. The only change we made to the benefit and cost estimates was to adjust all values to 2011 dollars by using the gross domestic product (GDP) deflators published by the U.S. Bureau of Economic Analysis.<sup>7</sup> Rules generally used real discount rates of 3 percent and 7 percent, and we recorded both.

Values for the SCC have changed over time. We recorded the value that was used in the benefit-cost analysis. The SCC was first used in regulatory analysis in 2008. In 2009, the government assembled the Interagency Working Group on Social Cost of Carbon to estimate values for the SCC and help bring consistency to values used by regulatory agencies. This group issued a report in 2010. Agencies then used these SCC values to estimate the benefits from reducing CO<sub>2</sub> emissions for selected regulatory activities (Greenstone, Kopits, and Wolverton 2013).

The interagency report directs agencies to use a global SCC, which considers the global benefits accruing to all countries combined as a result of reducing a metric ton of CO<sub>2</sub> emissions. The central value specified by the report is \$21 (in 2007 dollars) per metric ton of reduction in CO<sub>2</sub> emissions in 2010. It increases over time to reflect the greater marginal damages of global temperature changes associated with higher temperature levels. The discount rate used for determining the central value of the SCC is 3 percent (Interagency Working Group on Social Cost of Carbon 2010).

From August 2009 until the release of the first interagency report, all

7. US Department of Commerce, Bureau of Economic Analysis, National Data, table 1.1.9: Implicit Price Deflators for Gross Domestic Product (<http://www.bea.gov/iTable/iTable.cfm?ReqID=13&step=1#reqid=13&step=1&isuri=1>).

agencies used a central value of \$19 (in 2007 dollars) per metric ton of reduction in CO<sub>2</sub> emissions in 2007. Before this, each agency chose its own SCC estimates. For example, the EPA once used central estimates of \$68 and \$40 (2006 dollars) for a metric ton of emissions in 2007. The DOE once used a central estimate of \$33 (2007 dollars) for a metric ton of emissions in 2007.

In some cases, an agency used both a global and a domestic SCC for valuation. Unlike the global SCC value, the domestic value incorporates only benefits to the United States and is generally much lower than the global value. In those cases where a domestic value was given, we continued to record data on the benefits and costs associated with global values of the SCC. This choice is supported by the interagency report, which provides an estimate for the domestic SCC but recommends that agencies use the global SCC in their central estimates (Interagency Working Group on Social Cost of Carbon 2010).

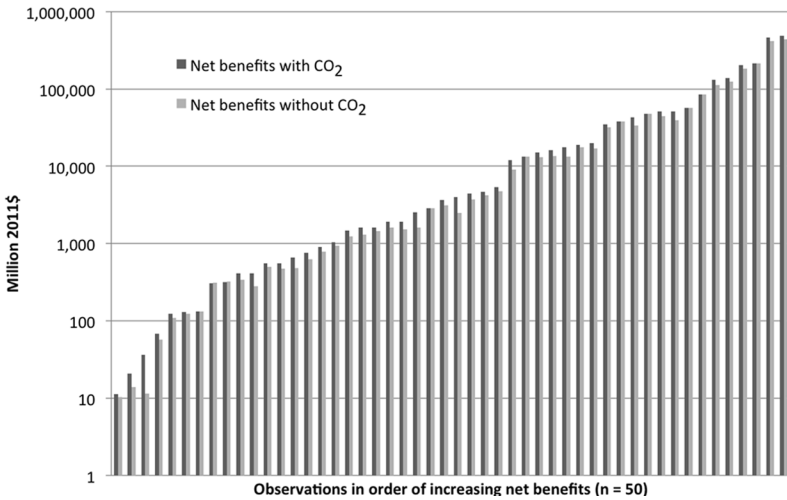
Prior to the issuance of this report, however, the DOE sometimes failed to draw a clear distinction between global and domestic values for the SCC. The agency provided a range that included both but stated that domestic values were likely to fall near the lower bound. Several rules used a range of \$0 to \$20. This approach made it impossible for us to separate the global estimates from the domestic ones, so we used the midpoint of the full range for our primary analysis. We also ran a sensitivity analysis in which we used the upper and lower bounds of the range.

### 3. RESULTS

The quantitative analysis first examines whether use of the SCC has had an impact on the net benefits of the selected alternative compared with the status quo. It then examines whether use of the SCC has changed the relative ranking of policy alternatives and whether this could have impacted policy.

#### 3.1. Comparing the Selected Alternative with the Status Quo

A key result is that using the SCC in the regulatory analyses did not generally change the sign of the benefit-cost analysis for the selected alternative. This result is shown in Figure 1, which shows the net benefits on a log scale at a 3 percent discount rate for the 50 benefit-cost analyses in the data set with positive net benefits (of a total of 53 analyses). The observations are ranked in terms of increasing net benefits. Regulatory policies are reported only if they provided a net benefit calculation and if they



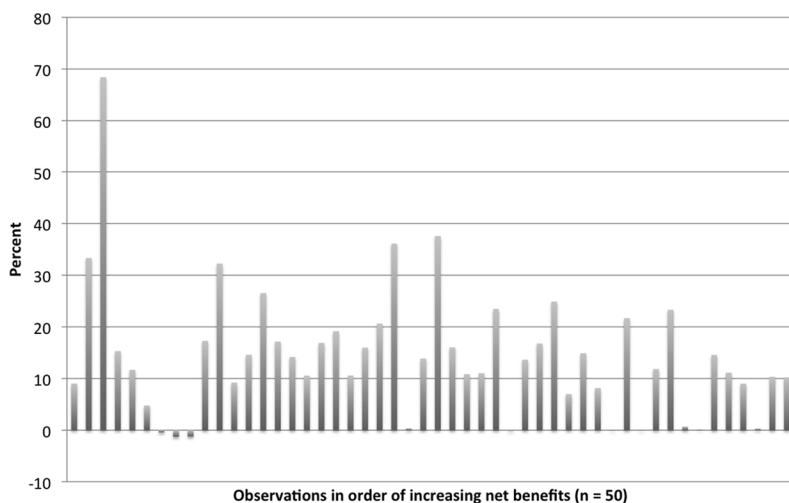
**Figure 1.** Net benefits with and without valuing CO<sub>2</sub>

valued changes in CO<sub>2</sub> emissions in that calculation. In cases in which a range of net benefits was presented at a 3 percent discount rate, we report the midpoint of those net benefits. The use of the midpoint does not affect our qualitative conclusions.

The three benefit-cost analyses we found for which net benefits were negative are not reported in Figures 1 or 2. The policies set limits on the emissions of hazardous air pollutants from commercial and institutional boilers and steam electric power generators.<sup>8</sup> Net benefits remained negative even after including the value of CO<sub>2</sub> reduction benefits, consistent with the finding in Figure 1. The EPA appears to have approved these policies because the Clean Air Act and the Clean Water Act require it to establish specific types of emissions standards for sources of hazardous pollutants. These regulatory decisions by the EPA are consistent with regulatory executive orders that require agencies to select alternatives where benefits justify costs to the extent permitted by law.

In addition to showing that the sign of the benefit-cost analysis does not change with the inclusion of CO<sub>2</sub> reduction benefits, Figure 1 reveals that the SCC has to date been taken into account for a very wide range of regulatory policies, for which net benefits vary over several orders of magnitude. The lowest net benefit for a regulatory policy was on the or-

8. Two of these policies are from the same regulation: they define effluent limitation standards for new and existing steam electric power generators. The three policies are indicated with asterisks in Table A1 in the online appendix.



**Figure 2.** Carbon dioxide reduction benefits as a percentage of net benefits, including CO<sub>2</sub>

der of \$10 million, while a few regulatory policies had net benefits that approached \$500 billion.

Figure 2 takes the same regulatory policies shown in Figure 1 and computes CO<sub>2</sub> reduction benefits as a percentage of total net benefits (but on an arithmetic scale). The CO<sub>2</sub> reduction benefits average about 14 percent across all regulatory policies, with a range of -2 to 70 percent. The cases for which the CO<sub>2</sub> net benefits are negative but overall net benefits are positive reflect a small increase in CO<sub>2</sub> emissions resulting from greater energy use. For example, the National Emission Standards for Hazardous Air Pollutants for Major Sources result in a slight increase in CO<sub>2</sub> emissions because boilers that meet the standards use slightly more energy than boilers that do not.

Instead of asking whether including CO<sub>2</sub> reduction benefits changes the sign of net benefits for a particular policy, we can explore the incremental impact of including CO<sub>2</sub> reduction benefits for particular policies. The data in Figure 1 show that CO<sub>2</sub> benefits account for 30 percent or more of total benefits in 10 percent of the cases (5 out of 50) and for 20 percent or more of total benefits in 22 percent of the cases (11 out of 50). In this sense, the incremental contribution of estimated monetary CO<sub>2</sub> reduction benefits is a nontrivial portion of net benefits for some policies.

We tried to explain the variation in CO<sub>2</sub> reduction benefits as a percentage of total net benefits across regulatory policies. We examined whether this difference might be explained by two factors: the agency

proposing the regulatory policy and the major source of benefits from that policy. The major sources of benefits for regulatory policy were divided into three categories: health benefits from reduced exposure to pollutants, fuel savings for vehicles and planes, and energy savings for equipment other than vehicles. We found that neither of these factors is important in explaining the variation in percentages across regulatory policies.<sup>9</sup>

The results in Figures 1 and 2 include all rules that use the SCC. Three rules were explicitly motivated by climate change considerations. All are greenhouse gas emission standards for vehicles. Since each of these rules is estimated to yield substantial benefits from fuel savings for vehicle owners, each has positive net benefits before the addition of CO<sub>2</sub> reduction benefits. Consequently, restricting the analysis to these rules does not change our conclusions.

We then considered the robustness of our conclusions in various dimensions, including changes in the discount rate, the level at which benefits and costs were aggregated, the use of different values for the SCC, and changes in the benefits associated with estimated fuel savings, which may be overstated.

Changes in the discount rate generally do not affect the qualitative results. We did find one class of equipment for which introducing CO<sub>2</sub> reduction benefits at a 3 percent discount rate changed the sign of net benefits when costs and non-CO<sub>2</sub> reduction benefits were evaluated at a 7 percent discount rate: class B beverage vending machines. Net benefits are relatively small in both cases, however; they increase from -\$3 million to \$9 million with the inclusion of CO<sub>2</sub> reduction benefits in the calculation.

We considered whether the results shown in Figures 1 and 2 apply to policies that are evaluated at a lower level of aggregation. For example, we checked whether CO<sub>2</sub> reduction benefits changed the sign of net benefits of fuel economy standards for several subcategories of heavy-duty vehicles. We performed the same exercise on 72 distinct disaggregated policies in the rules in our sample. In 70 of these cases, we found that the addition of CO<sub>2</sub> reduction benefits did not change the sign of net benefits

9. We also investigated a possible relationship between total net benefits and carbon dioxide (CO<sub>2</sub>) reduction benefits as a percentage of net benefits. We do not find strong evidence of a relationship between net benefits and CO<sub>2</sub> reduction benefits as a percentage of net benefits. For example, we regressed the percentage on levels and logarithms of total net benefits. The slope coefficient was negative and significant in the logarithmic regression, which indicates that a 1 percent increase in total net benefits is associated (on average) with a 2 percent reduction in CO<sub>2</sub> reduction benefits as a percentage of net benefits. Alternative specifications were not statistically significant.

at a 3 percent or 7 percent discount rate. The exceptions were vending machines and commercial air conditioning and heating equipment.

We considered what would happen if there were changes in the value of the SCC employed. In this analysis, the answer is “very little” because most benefit-cost analyses that we examined already pass a benefit-cost test without the addition of CO<sub>2</sub> reduction benefits, and, in most cases, the CO<sub>2</sub> benefits were positive.

As a final sensitivity check, we considered one particular adjustment to the data on fuel savings but did so using a bounding analysis. Fuel savings are a major benefit category in seven separate benefit-cost analyses included in five rules that we examined. However, there is some controversy over the correct way to account for fuel savings in certain purchases. Greenstone, Kopits, and Wolverton (2013, p. 43) exclude private fuel savings because “many consider the question of how consumers account for fuel savings in their purchase decisions an unsettled empirical question.”

Frequently, the value of fuel savings, and energy savings more generally, is based on engineering analysis. That may not be the right way to value such savings. For example, a consumer may value fuel savings from a new technology in an automobile, but she may also value other vehicle attributes, such as safety or lower emissions (Lave 1984). If these other attributes are not taken into account in the benefit-cost analysis, then the rule may overstate the benefits by focusing on fuel savings alone.

To address the issue that the estimated benefits from fuel savings may overstate actual benefits, we performed a sensitivity analysis on our data. We assumed that the benefits from fuel savings are 0, which is likely to be an extreme assumption. We examined seven benefit-cost analyses by the EPA and DOT that included fuel savings.

These analyses covered greenhouse gas emissions standards and fuel economy standards for vehicles of different weights and model years. Each cited fuel savings as the greatest benefit of the standards in question. We found only one analysis in which CO<sub>2</sub> benefits played a decisive role (once fuel savings were omitted). This analysis covered greenhouse gas emissions standards for light-duty vehicles sold in model years 2017–25 (2017 and Later Model Year Light-Duty Vehicle Greenhouse Gas Emissions and Corporate Average Fuel Economy Standards, 77 Fed. Reg. 62,623 [October 15, 2012]).

Another interesting issue arises with EPA greenhouse gas standards for vehicles. When issuing these standards, the EPA always performed a sensitivity analysis of its own data. It assumed that the standards would

be extended indefinitely and measured the net benefits through 2050. In all three cases, large fuel savings benefits ensured that the standards had positive net benefits before the addition of CO<sub>2</sub> reduction benefits. When we excluded fuel savings benefits, however, we found that the addition of CO<sub>2</sub> reduction benefits always changed the sign of net benefits. While we think this analysis is useful as a bounding exercise, we think the assumption that the same standards will be in place for such a long period is unrealistic and may lead to an overstatement of the benefits of those standards.

The preceding examples suggest that with a different, and perhaps more realistic, set of economic analyses, the SCC could have made a more pronounced difference in the selection of particular policies. In our conclusion, we suggest a way of shedding light on this issue by doing independent analyses of all rule makings.

### **3.2. The Social Cost of Carbon and the Relative Ranking of Policy Alternatives**

The analysis illustrated in Figures 1 and 2 focuses on the impact of including CO<sub>2</sub> reduction benefits on the policy alternative that was actually selected in each regulation. As noted above, it is possible that the inclusion of CO<sub>2</sub> reduction benefits affected the relative ranking of policy alternatives that the government considered and that this change in ranking led to a change in the selection of a particular policy alternative.

We addressed this issue in two ways. First, we searched the regulatory analyses for a discussion of net benefits that would suggest that the inclusion of CO<sub>2</sub> reduction benefits was an important or decisive factor in selecting the final policy. We found no such discussion in our search, which does not lend support to the notion that use of the SCC was a critical factor in decision making. The keywords and phrases used in our search included “social cost of carbon,” “CO<sub>2</sub> emissions,” and “CO<sub>2</sub> benefits.”

We also tried a quantitative approach to this problem. We searched for policy analyses of rules, and parts of rules, that provided benefit and cost information about the selected alternative and at least one rejected alternative.<sup>10</sup> This exercise revealed that there is widespread variation

10. In many cases, these regulatory alternatives differed in terms of the stringency of the standard. For example, the four alternatives to the DOE’s energy conservation standards for residential clothes washers were simply more and less stringent versions of the final standards. The standards were defined in terms of energy-savings and water-savings targets that could be met with existing technologies that were on the market.

across regulatory agencies in the extent to which they quantify the benefits of changes in the value of CO<sub>2</sub> emissions.

We encountered two difficulties in this exercise. First, the EPA rarely provided estimates of net benefits for alternatives, and the DOT rarely provided estimates of CO<sub>2</sub> benefits for alternatives. Even after checking regulatory impact analyses and technical support documents, we found sufficient information in only one-third of the rules issued by the EPA or DOT. We found sufficient information in all of the rules issued by the DOE. Consequently, our data set for this exercise was heavily biased toward rules issued by the DOE.<sup>11</sup>

Second, agencies that did provide information on rejected alternatives often used a lower level of aggregation than they used in their presentation of selected alternatives. For example, the DOE conducted three separate cost-benefit analyses for three different types of distribution transformers. Although the agency combined the three to obtain a net benefit estimate for the standards it selected, it did not do the same for standards it rejected. We addressed this problem by using the highest level of aggregation provided by the agency (that is, the level of aggregation at which the agency actually made its decisions among various alternatives). If we had aggregated the data further, we would have lost useful information about decisions that considered a range of alternatives.

Our final data set for this exercise contains 43 policies that provided benefit and cost information on at least one rejected alternative other than the status quo and the preferred policy. Of those 43 policies, we found 12 for which the inclusion of CO<sub>2</sub> reduction benefits actually changed the alternative that maximized quantitative net benefits. We also identified 20 of 43 policies for which the inclusion of CO<sub>2</sub> reduction benefits changes the relative ranking of at least two alternatives. This change in ranking suggests that the SCC has had some effect on the economic analysis.

Determining whether the change in ranking had an impact on the policy choice is more difficult. For six of the 12 policies for which including CO<sub>2</sub> benefits changed the alternative that maximized net benefits, the alternative with the highest quantified net benefits was selected. On the surface, this finding might appear to lend some support for the hypothesis that CO<sub>2</sub> benefits were important in the final policy decision for a small but nontrivial group of policies.

11. We checked whether proposed rules contained more information on rejected alternatives than final rules did. In general, they did not. We found 38 proposed policies (36 of which were rules issued by the DOE) that provided sufficient information about the net benefits of rejected alternatives. We analyzed these policies and found that they support our main qualitative findings.

There is a problem with this conclusion, however. No requirement in the presidential executive order governing regulations says that the policy with the maximum quantifiable net benefits must be selected. Furthermore, sometimes statutes limit the scope for selecting the alternative that maximizes net benefits. In the case of energy conservation standards, for example, the DOE uses seven statutory factors to determine whether the benefits of an energy conservation standard exceed its burdens. Those factors are the economic impact on manufacturers and consumers, the operating cost savings, energy and water savings, reduction in product utility or performance, reduction in competition, the need of the nation to conserve energy and water, and other factors deemed relevant by the Secretary of Energy (42 U.S.C. sec. 6295[o])[2])[B])[i]). The DOE can use these factors to justify a decision even if it has not included that factor in the relevant net benefit estimates. That is, it can conclude that the costs of a policy exceed its benefits even though its estimated net benefits are large and positive.

To obtain an estimate, admittedly crude, of the proportion of cases in which the addition of CO<sub>2</sub> benefits affects regulatory decisions, we use the following equation:

$$\begin{aligned}
 & (\% \text{ of cases in which including CO}_2 \text{ benefits changes the decision}) \\
 & = (\text{Increase in the likelihood that a policy alternative is} \\
 & \quad \text{chosen from being ranked in the first position}) \quad (1) \\
 & \times (\% \text{ of cases in which including CO}_2 \text{ benefits moves} \\
 & \quad \text{a policy alternative to the first position}).
 \end{aligned}$$

We assume for simplicity that the two terms on the right-hand side of equation (1) are independent, that each regulation considers the same number of policy alternatives, and that all alternatives below the first position are equally likely to be chosen. The last assumption allows us to focus only on those cases for which the SCC changes the top-ranked alternative.<sup>12</sup> Intuitively, we are trying to estimate the impact of the SCC in terms of the frequency with which using the SCC shifts a policy alternative to being ranked first, together with the value of being ranked first (in terms of making it more likely to be chosen by the agency).

To compute the first term on the right-hand side of equation (1), note that regulators selected the top-ranked alternative in 58 percent of all

12. If the SCC does not move a policy's rank to the first position, it does not change the probability that it is selected, so the SCC is assumed to have no impact on the likely choice of particular decisions. This allows us to focus only on those cases in which the SCC moves a policy alternative to the first position.

cases (25 of 43). The average number of alternatives considered in the 53 rules was 4.7. Assuming that the remaining alternatives were equally likely to be chosen means that they each were selected 11 percent of the time.<sup>13</sup> Taking the difference between 58 and 11 percent gives 47 percent, which provides a best estimate of the first term on the right-hand side of equation (1). Our estimate of the second term is 12 of 43 cases, or 28 percent. Multiplying these two percentages yields an estimate that the SCC may have changed decisions in about 13 percent of the cases.<sup>14</sup> We conclude from this exercise that introduction of the SCC may have affected the final decision in roughly one of eight cases.

The preceding analysis is based on a stylized model that makes many assumptions. An alternative model that we constructed had the counterfactual consist of policies that were randomly selected. In that model, the impact of the SCC on decisions would generally be smaller than estimated here. Our goal here is simply to provide some novel estimates of the impact of the SCC. While recognizing that several different approaches exist, we do not pretend to be able to offer a precise final answer.

#### 4. CONCLUSION AND AREAS FOR FUTURE RESEARCH

We evaluated a recent innovation in US regulatory policy: the use of the SCC to value changes in emissions of CO<sub>2</sub>, a greenhouse gas. To assess whether outcomes were affected, we considered the net benefits for 53 regulatory policies from 2008 through 2013, with and without estimates of the benefits associated with changes in CO<sub>2</sub> emissions. We find that including the benefits from expected changes in CO<sub>2</sub> emissions does not typically affect the ranking of the preferred policy compared with the status quo. This is true even for policies explicitly aimed at reducing CO<sub>2</sub> emissions.

In some cases, including benefits from reductions in emissions does change the relative ranking of different policy alternatives. We considered how changes in ranking were affected by the introduction of the SCC and found that including CO<sub>2</sub> reduction benefits may matter in roughly one of eight cases.

A general limitation of our quantitative analysis is that we take the

13. The calculation is  $(1 - .58)/4.7$ .

14. We examined the sensitivity of our results to the average number of alternatives. If there were four alternatives per rule, our formula for the impact of the SCC would yield 12.3 percent instead of 13.1 percent. If there were five alternatives per rule, it would yield 13.3 percent.

regulatory benefits and costs calculated by the agency as given. We do not know the biases that exist in these data, and there is relatively little work that provides a definitive assessment on the nature of these biases (Hahn and Tetlock 2008). One way of addressing the bias issue would be to perform independent analyses of the economic benefits and costs of these rule makings (Harrington, Morgenstern, and Nelson 2000). Such analyses are labor intensive but could help furnish insights into the underlying political economy.<sup>15</sup>

This analysis raises at least three key issues, all of which deserve further scrutiny. One is the question of how the pattern in the data can be explained. The absence of a marked impact may be explained in part because US regulators have succeeded in selecting the low-hanging fruit, where the net benefits of a policy that reduces CO<sub>2</sub> are positive. Another possible explanation is that the SCC is so small that it will never make a difference. We view this as highly unlikely in light of the findings presented above. The CO<sub>2</sub> reduction benefits average roughly 15 percent of the net benefits for the data considered here. A further explanation, which we also rejected, is that our sample considers only economically significant regulations (for example, regulations whose impact exceeds \$100 million), which are likely to pass a benefit-cost test; otherwise, the argument is that they would not be proposed. We reject this argument on the basis of the work of regulatory scholars that finds that many economically significant regulations do not pass a benefit-cost test even when the government's own numbers are used (for example, Morrall 1986; Hahn 2000).

A second critical issue is why the United States chose to implement the SCC, given that it appears to have made little actual difference for policy to date. One possible explanation is that regulators may have thought that it was appropriate to value carbon in federal regulatory decisions related to climate, taking into account global damages. The reports of the Interagency Working Group on Social Cost of Carbon support this view. An alternative explanation, not necessarily inconsistent with the former one, is that the SCC may have been attractive for the executive branch to pursue because it gave the appearance of doing something on climate policy (an issue that President Barack Obama put high on his agenda). At the same time, Congress may have found this acceptable because it probably

15. We also conjecture that such an analysis could lead to a larger number of cases in which inclusion of the SCC changed the sign of net benefits of the policy from negative to positive. This is because some benefits that the agencies count may not be appropriate to count or may be overstated.

had little real impact on policy, at least so far. Finally, there may have been an expectation that estimates of the SCC may increase over time and thus have a more pronounced impact on regulatory decisions (see, for example, Moyer et al. 2014).

A third issue relates to whether agencies are selecting policies that maximize expected net benefits. Frequently, an agency does not present sufficient information in the benefit-cost analysis to allow a reader to ascertain whether the outcome selected maximizes net benefits (Hahn and Tetlock 2008). We know from the benefit-cost analyses reviewed here that agencies are generally selecting policies that have positive net benefits relative to the status quo. We do not know whether the selected policy actually maximizes net benefits compared with other alternatives. We do know, however, from an earlier discussion that regulators selected the top-ranked alternative in 58 percent of cases examined, which means they did not do so in 42 percent of the cases. The selection of an economic alternative with lower quantified net benefits may have been made for several reasons, such as consideration for nonquantifiable benefits, concerns with equity, or politics.

Regulatory agencies could address this issue by being clearer about the nature of the particular net benefit function they are trying to maximize (for example, specifying which externalities are included). They could also quantify the benefits and costs associated with a larger number of alternatives, so that the interested independent analyst could compare net benefits for different alternatives (Arrow et al. 1996). This is especially important to do for marginal net benefits. In the case of the SCC, we would conjecture that introduction of the SCC would likely make a difference for the optimal policy choice, much in the same way a Pigovian tax makes a difference, by lowering the optimal level of pollution.

## REFERENCES

- Anthoff, David, Elizabeth Baldwin, Scott Barrett, Linda Cohen, Diane Coyle, Partha Dasgupta, et al. 2011a. Thinking through the Climate Change Challenge. Open letter. January 16. *VoxEU.org*. <http://www.voxeu.org/article/thinking-through-climate-change-challenge>.
- Anthoff, David, Steven Rose, Richard S. J. Tol, and Stephanie Waldhoff. 2011b. Regional and Sectoral Estimates of the Social Cost of Carbon: An Application of FUND. Economics Discussion Paper No. 2011-18. Kiel Institute for the World Economy, Kiel.
- Arrow, Kenneth J., Maureen L. Cropper, George C. Eads, Robert W. Hahn, Les-

- ter B. Lave, and Roger G. Noll, et al. 1996. Is There a Role for Benefit-Cost Analysis in Environmental, Health, and Safety Regulation? *Science*, April 12, pp. 221–22.
- Broome, John. 2012. *Climate Matters: Ethics in a Warming World*. New York: W. W. Norton & Co.
- Coase, R. H. 1960. The Problem of Social Cost. *Journal of Law and Economics* 3:1–44.
- Ellerman, A. Denny, and Barbara K. Buchner. 2007. The European Union Emissions Trading Scheme: Origins, Allocation, and Early Results. *Review of Environmental Economics and Policy* 1:66–87.
- Gayer, Ted, and W. Kip Viscusi. 2014. Determining the Proper Scope of Climate Change Benefits. Working paper. Brookings Institution, Washington, DC.
- Greenstone, Michael, Elizabeth Kopits, and Ann Wolverton. 2013. Developing a Social Cost of Carbon for US Regulatory Analysis: A Methodology and Interpretation. *Review of Environmental Economics and Policy* 7:23–46.
- Hahn, Robert W. 2000. *Reviving Regulatory Reform: A Global Perspective*. Working paper. American Enterprise Institute–Brookings Joint Center, Washington, DC.
- Hahn, Robert W., and Robert A. Ritz. 2014. Optimal Altruism in Public Good Provision. Working paper. Oxford University, Smith School of Enterprise and the Environment, Oxford.
- Hahn, Robert W., and Paul C. Tetlock. 2008. Has Economic Analysis Improved Regulatory Decisions? *Journal of Economic Perspectives* 22:67–84.
- Harrington, Winston, Richard Morgenstern, and Peter Nelson. 2000. On the Accuracy of Regulatory Cost Estimates. *Journal of Policy Analysis and Management* 19:297–332.
- Interagency Working Group on Social Cost of Carbon. 2010. *Technical Support Document: Social Cost of Carbon for Regulatory Impact Analysis under Executive Order 12866*. Washington, DC: Interagency Working Group on Social Cost of Carbon. February. <http://www.epa.gov/otaq/climate/regulations/scc-tsd.pdf>.
- . 2013. *Technical Support Document: Technical Update of the Social Cost of Carbon for Regulatory Impact Analysis under Executive Order 12866*. Washington, DC: Interagency Working Group on Social Cost of Carbon. May. [http://www.whitehouse.gov/sites/default/files/omb/inforeg/social\\_cost\\_of\\_carbon\\_for\\_ria\\_2013\\_update.pdf](http://www.whitehouse.gov/sites/default/files/omb/inforeg/social_cost_of_carbon_for_ria_2013_update.pdf).
- Kopp, Robert E., and Bryan K. Mignone. 2012. The U.S. Government’s Social Cost of Carbon Estimates after Their First Two Years: Pathways for Improvement. *Economics: The Open-Access, Open-Assessment E-Journal* 6:1–41.
- Lave, Lester B. 1984. Controlling Contradictions among Regulations. *American Economic Review* 74:471–75.
- Metcalf, Gilbert, and David Weisbach. 2009. The Design of a Carbon Tax. *Harvard Environmental Law Review* 33:499–556.

- Morrall, John. 1986. A Review of the Record. *Regulation* 10:25–34.
- Moyer, Elisabeth J., Mark D. Woolley, Nathan J. Matteson, Michael J. Glotter, and David A. Weisbach. 2014. Climate Impacts on Economic Growth as Drivers of Uncertainty in the Social Cost of Carbon. *Journal of Legal Studies* 43:401–25.
- Nordhaus, William D., and Joseph Boyer. 2000. *Warming the World: Economic Models of Global Warming*. Cambridge, MA: MIT Press.
- Pigou, Arthur C. 1920. *The Economics of Welfare*. London: MacMillan.
- Stavins, Robert N. 2007. A U.S. Cap-and-Trade System to Address Global Climate Change. Discussion Paper No. 2007-13. Brookings Institution, Washington, DC.
- Tol, Richard S. J. 2009. The Economic Effects of Climate Change. *Journal of Economic Perspectives* 23(2):29–51.
- Watkiss, Paul, and Thomas Downing. 2008. The Social Cost of Carbon: Valuation Estimates and Their Use in UK Policy. *Integrated Assessment Journal* 8:85–105.
- Watkiss, Paul, and Chris Hope. 2011. Using the Social Cost of Carbon in Regulatory Deliberations. *Wiley Interdisciplinary Reviews: Climate Change* 2:886–901.