

WHY THE POTENTIAL COMPENSATION TEST IS NOT SATISFACTORY

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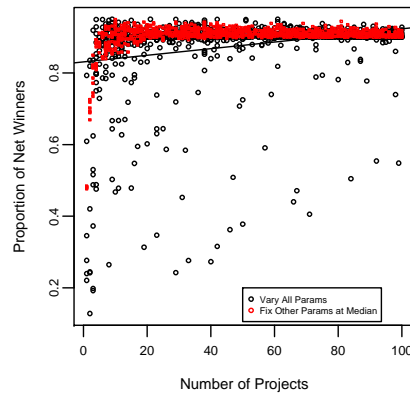
Seattle, WA

The Potential Compensation Test is Not Satisfactory

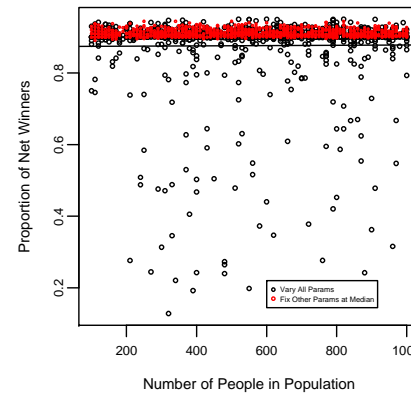
- 1. NO ACTUAL COMPENSATION**
- 2. Does not work for law**
- 3. Scitovsky Reversals**
- 4. A Better Alternative is Available**

Expanded Kaldor-Hicks: The Better Alternative

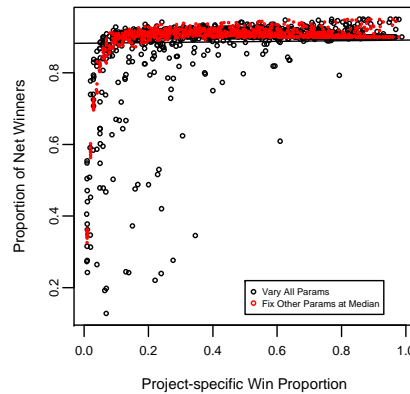
Proportion of Winners vs. Project #



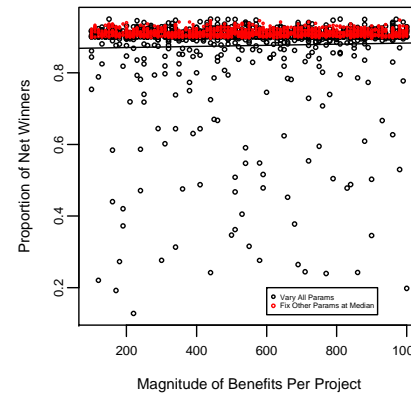
Proportion of Winners vs. Pop. Size



Proportion of Winners vs. Project Winners



Proportion of Winners vs. Project Benefits



THE DISCOUNT RATE : SOURCES OF DISAGREEMENT

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Approaches

- Rate of return to private sector (marginal rate of transformation)
- Time preference rate
- Weighted average of rate of return and time preference (SOC OR OCC, STP)
- Social welfare function (Ramsey rate and ethical rates)
- Time declining rates can be used with above rates

Strategy for Consensus

- MUST FIRST AGREE ON FUNDAMENTAL PRINCIPLES.
- PRINCIPLE ONE: A discount rate should require that no project be accepted if its return is less than the return available on alternative projects
- PRINCIPLE TWO: separate the rate from extraneous matters, (e.g. ethical concerns) which are any matters than can reasonably be separated

Effects of Fundamental Rules

1. Eliminates pure time preference rates
 2. Eliminates pure rate of return to private capital
 3. Eliminates ethically based rates
-
4. Leaves soc, stp and time declining rates.

Time Declining Rates

- The justification from knowledge
- The justification from risk

Recent Work Re: Time Declining Rates

Table 1

Arrow et al. Discount Rates

Present values of \$1,000 realized at various future times and certainty equivalent rates.

Time in years	1% interest rate Present Value	7% interest rate Present Value	Average Expected Present Value	Certainty Equivalent Rate
1	990.05	932.22	961.22	3.94%
10	904.84	469.59	700.71	3.13%
100	367.88	0.91	184.40	1.02%

Time Declining Rates Using a Different Set of Time Preference Rates

Time in Years	6 percent interest Present Values	7 percent interest Present Values	8 percent interest Present Values	Average Expected Present Value	Certainty Equivalent Rate
1	941.76	932.39	923.11	932.43	7.00%
10	548.81	496.59	449.33	498.24	6.97%
100	2.47875	0.91	000.33546	001.242	6.69%
1000	875.65E-26	397.54E-29	180.49E-33	292.00E-25	6.11%