Conference

The discount rate in the evaluation of public investment projects

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Key Issues for Applied Public Sector Discounting

An outline of key Issues based on UK experience

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- It is important to base decisions about the discount rate on the purpose and role that discounting plays in the real world context of public finance.

- The abstracted theoretical model of discounting familiar to economists and accountants is based on a model in which the sum of individual investment spending decisions determines the total level of investment spending.

- The real context of public sector decisions differs from this theoretical model and we have to consider the purpose of discounting and how it works in this context in terms of decision theory.

- Who decides what and when and how
    - Policy Subjects and initiatives are largely exogenously politically determined they are not the result of discounting.
    - Officials are required to use objective techniques to give advice to elected decision makers so the process is not a deterministic calculator.
    - CBA and CEA are of immense value but also have limitations. In a real context there must always be a strategic level choice that frames the spending options that are to be analysed using CBA or CEA.
    - HM Treasury uses its “five dimensional model” for structuring decisions so balancing net public benefit measured with approaches derived from welfare economics against whole life costs.
    - Most importantly the public budget for investment is predetermined it is not the result of a sum of individual decisions resulting from CBA. Instead it is a policy determined

macro level decision and allocation of funds to departments is a politically mediated rationing process.

  - Investment spending decisions are about the opportunity cost of alternative investment decisions either choosing between projects or between options for designing a particular project. They use capital from the politically predetermined fixed capital pool which will be spent in one way or another.
  - Risk results from the need to implement politically agreed policies, the public sector cannot cherry pick risk in the same way as an insurance company or an investment fund. There is therefore value for the public sector in identification and analysis of specific risks and in actively seeking to manage, avoid or share risk if possible. Therefore it is sensible to price and arrange to manage the risks of alternative implementation options.
  - Risk costs are generally therefor not included in the discount as a risk premium but instead risks are objectively estimated on an expected value basis and included in the costs of a proposal, including from the beginning the costs of optimism bias.

- The role of CBA and discounting in this environment is to enable proposals of different time spans and with different cost benefit profiles to be considered on a common present value basis. This is a form of “normalising” it is not directly dependent on the cost of capital or proposal specific risk. Hence the Ramsey formula is an appropriate formulation to use to provide an estimate of the social discount rate.

- It is important to be able to compare proposals made at different times so there is great advantage in having a stable discount rate and nothing to gain from any link to capital costs.