I. Revealed Preference Approaches (continued)

B. Travel Cost Method

- The travel cost method looks at how far visitors travel to come to a site.
- By placing a value on the cost of travel, we can infer the value of the site.
  - The travel cost includes both direct costs (e.g. airfare) and indirect costs (e.g. the opportunity cost of travel time).
  - We can infer the value of a change in quality by looking at demand during different days (e.g. in different types of weather).
- Travel cost example. Consider a survey that collects data on the number of visits a person makes to a beach.
  - Based on how far they travel, the survey includes an estimate of the travel cost for each person.
  - Suppose we also have data on how many more trips they would make if the water quality were higher.
  - These data are given in the chart below:

<table>
<thead>
<tr>
<th></th>
<th>Travel Cost</th>
<th># of visits before</th>
<th># of visits after</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>0.9</td>
<td>31</td>
<td>35</td>
</tr>
<tr>
<td>B</td>
<td>1.95</td>
<td>20</td>
<td>27</td>
</tr>
<tr>
<td>C</td>
<td>3</td>
<td>16</td>
<td>22</td>
</tr>
<tr>
<td>D</td>
<td>3.95</td>
<td>13</td>
<td>16</td>
</tr>
<tr>
<td>E</td>
<td>5</td>
<td>7</td>
<td>12</td>
</tr>
</tbody>
</table>
This graph shows the scatter plot of these data, along with the regression line that best fits the data:

Using the estimated demand functions, we can calculate the consumer surplus before and after. The change in consumer surplus is the value of improved water quality.

For simplicity, we’ll assume there is no admission fee for the beach, so that the price is 0 – anyone willing to travel to the beach can use it.

Rounding to simplify the math, we have two demand curves:
- **Before:** \( P = 6-0.175Q \)
- **After:** \( P = 7-0.175Q \)
To calculate the areas of these, we need Q when P = 0

- Before: 6 = 0.175Q
  - Q = 6/0.175 = 34.3
- After: 7 = 0.175Q
  - Q = 7/0.175 = 40

Our graph is thus:

![Demand Graph](image)

- The area between the two demand curves is the additional consumer surplus resulting from better water quality.
  - CS After = 0.5(7)(40) = $140
  - CS Before = 0.5(6)(34.3) = $102.9
  - Change in CS = $37.10

- Compare single-site vs. multiple site models
  - Single site looks at how value changes as access to a site changes (e.g. closing a lake due to poor water quality)
    - Doesn’t address possible substitutes
      - If one lake closes, can go to a nearby lake
  - Multiple-site models consider the choice of which site to visit
    - Include distance (or travel cost) to neighboring sites as additional controls
    - Key question: what are the relevant sites in the choice set?
      - e.g. 1000’s of lakes in Minnesota – do we include them all
Potential problems with the travel cost method

1. What is the opportunity cost of time?
2. Only measures value of those that use the amenity. We need to account for substitutes.
   - For example, do all beach users in Florida come for the beaches, or are they there for other reasons (e.g. Disney)?
3. Sampling bias in surveys.

C. Hedonic Pricing Techniques: Housing

- Hedonic pricing techniques look at the value that people place on the attributes of a good.
  - That is, it assumes that people don't value a house itself, but rather the features of a house (e.g. number of rooms, location, is there a fireplace)
  - One such feature is environmental quality.

- Using regression analysis, we can find the correlation between housing prices and environmental quality in an area.

- Most studies find an elasticity of housing prices with respect to pollution that is around 0.1.
  - That is, a 1% decrease in pollution leads to a 0.1% increase in housing prices.

Example

- Data are median house prices and community characteristics
- Includes data on NOx concentrations in each neighborhood
- Consider first a regression of just prices and NOX.
  - Both are in logs so can interpret as elasticities.

```
. reg lprice lnox

Source |       SS           df       MS      Number of obs   =       506
-------------+----------------------------------   F(1, 504)       =    180.36
Model |  22.2916457         1  22.2916457   Prob > F        =    0.0000
Residual |  62.2906252       504   .12359251   R-squared       =    0.2635
-------------+----------------------------------   Adj R-squared   =    0.2621
Total |  84.5822709       505  .167489645   Root MSE        =    .35156

------------------------------------------------------------------------------
lprice |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
------------------------------------------------------------------------------
lnox |  -1.043143   .0776728   -13.43   0.000    -1.195746    -.890541
    _cons |   11.70719   .1324326    88.40   0.000     11.44701    11.96738
------------------------------------------------------------------------------
```

- The elasticity is -1.04. A 10% increase in NOx concentrations reduces prices by 10.4%. 
But, this model ignores controls. Add the following variables:

- rooms: average # of rooms per house
- ldist: log of weighted distance to 5 employment centers
- lproptax: log of property tax rate per $1000
- stration: average student-teacher ratio
- crime: crimes committed per capita

```
.reg lprice lnox ldist rooms stratio lproptax crime
```

<table>
<thead>
<tr>
<th>Source</th>
<th>SS</th>
<th>df</th>
<th>MS</th>
<th>Number of obs</th>
<th>F(6, 499)</th>
<th>Prob &gt; F</th>
<th>Adj R-squared</th>
<th>Root MSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td>55.7902689</td>
<td>6</td>
<td>9.29837815</td>
<td>506</td>
<td>161.15</td>
<td>0.0000</td>
<td>0.6555</td>
<td>0.24021</td>
</tr>
<tr>
<td>Residual</td>
<td>28.792002</td>
<td>499</td>
<td>0.057699403</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>84.5822709</td>
<td>505</td>
<td>0.167489645</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| lprice   | Coef.  | Std. Err. | t    | P>|t|   [95% Conf. Interval] |
|----------|--------|-----------|-----|-------|------------------------|
| lnox     | -.8076 | .1143758  | -7.06| 0.000 | -1.032308 -.5828729   |
| ldist    | -.2123 | .0398586  | -5.33| 0.000 | -.2906474 -.1340248  |
| rooms    | .2461  | .0168155  | 14.64| 0.000 | .2130801 .2791558   |
| stratio  | -.0384 | .0057099  | -6.73| 0.000 | -.0496586 -.0272219  |
| lproptax | -.0899 | .0415893  | -2.16| 0.031 | -.1715839 -.0081607  |
| crime    | -.0137 | .0015339  | -8.93| 0.000 | -.0167141 -.0106866  |
| _cons    | 11.31  | .3203163  | 35.30| 0.000 | 10.67686 11.93553   |

- The elasticity falls to -0.8.
  - A 10% increase in NOx concentrations reduces prices by 8%.

To get a value for reducing pollution, we need to know current home values and the number of homes affected.

- The median home value in this data set is about $22,500.
- Suppose there are 1 million homes in this region.
- A 10% reduction in NOX concentrations would increase the median home value by $2,250.
- Multiplying by 1,000,000 gives us a total value of $2,250,000,000 ($2.25 billion)

**D. Hedonic Pricing Techniques: Wages**

- Another application of hedonics is with wages.
- Examples:
  1. People will choose to live in cities with positive characteristics.
     - Differences in wages can be seen as the value of these characteristics.
  2. People need to be compensated to be willing to take riskier jobs.
     - Differences in wages represent the value of a human life.
II. Value of a Statistical Life

- The most controversial aspect of cost-benefit analysis is placing a value on human life.
  - What is the value?
    - Is it merely the opportunity cost (e.g. foregone wages)?
    - Are there other values (perhaps non-market values) that need to be considered?
  - Concepts of the value of a life
    - The most commonly used value is the value of a statistical life.
      - We don’t know who will die, but we expect someone will.
      - The value of environmental protection is lessening the risk of someone dying.
        - Note that specific deaths capture the attention of individuals. However, that is not what a statistical life focuses on.
      - We are valuing changes in the probability that a random individual will die, by asking what is the willingness to pay for changes in risk.
        - Cameron refers to VSL as the marginal rate of substitution between mortality risk and money.
        - It is the ratio of marginal utility of a small risk reduction over marginal utility of income: \(\text{VSL} = \frac{\text{MURisk reduction}}{\text{MUIncome}}\).
      - For policy, this is the most appropriate measure, because policy does not prevent death, but rather changes the probability that death will occur.
      - Can also be put into annual figures: value of a statistical life year (VSLY)
        - Contrast this with the optimal insurance and compensation of accident victims.
          - Here, things such as the opportunity cost of foregone wages and medical expenses make sense, since now we are focusing on a specific loss.
  - How to measure the value of a life:
    - Revealed preference approaches
      - Expenditures to reduce risk
        - For example, how much more will people spend for a car with airbags, or for bottled drinking water?
        - Challenge: separating value assigned to changing risk to other characteristics (e.g. other features of the car, or better taste for bottled water)
• Hedonic wage approach
  • People need to be compensated to be willing to take riskier jobs.
    • Differences in wages represent the value of a human life.
  • To calculate, we regress wages on job characteristics, worker characteristics, and risk
  • Key is to compare risk of jobs and compensation required for each.
    • Occupation 1: 1 in 10,000 risk of death per year
      • As a result, 1 worker dies every 10,000 years.
      • If 10,000 workers in this occupation, expect 1 to die each year.
    • Occupation 2: 3 in 10,000 risk of death per year
      • As a result, 3 worker dies every 10,000 years.
      • If 10,000 workers in this occupation, expect 3 to die each year.

• Comparison
  • Difference in risk is 2 in 10,000
  • Suppose wages in occupation 2 are $1,000 higher. What is the value of a statistical life?
    • The value is the willingness to pay to avoid a risk that results in one more death in the population.
    • This is the wage differential divided by the additional risk
      = $1,000/0.00002 (or 1,000/(2/10,000))
      = $5,000,000
  • Note that this assumes people’s preferences are linear.
    • Does $1,000 for 1/1000 => $100 for 1/10,000?

• Issues:
  • Requires people to have perfect information about risks, and to be able to evaluate this information properly.
  • Do people take risks knowingly and willingly?
    • True locally (that is for marginal changes), but for large changes in risks might not be appropriate.
      o Ask people: stated preference methods
        • We will discuss these in the next class
• Estimates of the value of a life in the United States vary by agency. These values were in effect in 2011:
  o E.P.A. $9.1 million
  o F.D.A. $7.9 million
  o DOT: $6 million
• Issues for valuing life
  o WTP depends on:
    ▪ Type of risk
    ▪ Amount reduced for each individual
    ▪ Income
    ▪ Substitutes: other ways to mitigate or avoid the risk
    ▪ Preferences: each individual's subjective disutility from the risk, their risk aversion, and discount rate
  o How do we deal with different groups?
    ▪ Reducing risk extends one's life expectancy.
    ▪ Given this, should we place different weights on the lives of children?
    ▪ Should we place less value on protecting the elderly?
      ▪ EPA explored this idea in 2003
      ▪ In some cases (e.g. air pollution), it is these high risk groups who are most affected by a policy.
      ▪ OMB guidelines advise against adjusting VSL for age.
  o Extrapolating results across groups can be a problem.
    ▪ Many VSL studies look at job risk in middle-aged men. However, the young and old tend to be most vulnerable to pollution.
    ▪ Estimating VSL for children particularly difficult.
      ▪ Cannot ask them directly
      ▪ Parents often willing to pay more to reduce risk to children than to themselves.
  o Should the value of human life vary by income?
    ▪ Studies such as those focusing on lost income will place more weight on high-income lives.
    ▪ Also, empirical work suggests income elasticity for WTP of risk reduction close to 1.
      ▪ EPA study finds a range between 0.08-1, with a mode of 0.4 for VSL.
    ▪ Given this, should we pay more to reduce risk if high-income people are affected?
      ▪ For example, the average income of air travelers is higher than for the population as a whole.
      ▪ Moreover, the costs of increased air safety will be passed on to these passengers via higher ticket prices.
      ▪ Given this, should the standards for air safety be higher?
    ▪ The EPA does not adjust VSL for incomes within a cross-section (e.g. doesn't say VSL higher for richer neighborhoods than for poorer ones). However, EPA adjusts VSL upward over time to account for higher incomes.
Cameron argues it should remain disaggregated at the individual level “through many steps”:

- Identification of individual risk reduction
- Multiplication of marginal WTP to get WTP for the size of risk reduction in question

Should also consider individual marginal costs to be able to get net benefits.

Only then should the results be aggregated

- In practice, most benefit-cost studies identify individual physical risk reductions and then go right to aggregation.
- This is the number of people “saved” by a policy

What are the potential biases of early aggregation?

- We often care about distributional consequences of a policy. Aggregation doesn’t provide information on distribution
  - E.g. a policy may have bigger impacts in lower-income neighborhoods
  - Suppose the costs are also borne by these neighborhoods? What should policy recommend?
- Risk reductions may not be distributed evenly across the population
- Thus, risk reduction and marginal WTP are potentially correlated
  - Note that E[XY] = E[X]E[Y] + Cov[XY]. Thus, only equal to the product of the average risk reduction and average WTP if these are not correlated.
  - VSL understated if WTP positively correlated with individual risk reductions
    - e.g. those at higher risk WTP more to reduce their risk
  - VSL overstated if WTP negatively correlated with individual risk reductions (e.g. highest risk in low-income neighborhoods)

What about people in other countries?

- These approaches suggest a lower value for lives in developing countries.
- Does ability to pay matter?
- Does it matter if we are considering a plan to be paid for by the Chinese government versus one sponsored by the U.S. to aid China?
  - If China is paying, their ability to pay constrains what they can do.

Control matters

- Smoking vs. workplace safety
- Driving vs. airline safety

Values can change over time

- Not having lifeboats for lower class passengers on the Titanic would be unacceptable now.
- Note that this may mean values also vary across culture or country.