

Chapter 13

>> Efficiency and Equity

Section 3: Efficiency and Equity

We have now shown why a perfectly competitive market economy is typically efficient: there is no way to make some people better off without making others worse off.

This conclusion refutes the claims of would-be economic planners, who insist that markets are disorganized free-for-alls and that centralized decision making would be more efficient. But we need to be careful: it is easy to get carried away with the idea that markets get it right and to then draw inappropriate conclusions about economic policy.

It's important to remember that efficiency is about *how to achieve goals*; it does not say anything about what your goals should be. Saying that the market outcome is efficient doesn't mean that that outcome is necessarily desirable. In fact, in some circumstances a well-thought-out economic policy may deliberately choose an outcome that is *not* efficient.

When can an outcome be efficient without being desirable? When it's not fair.

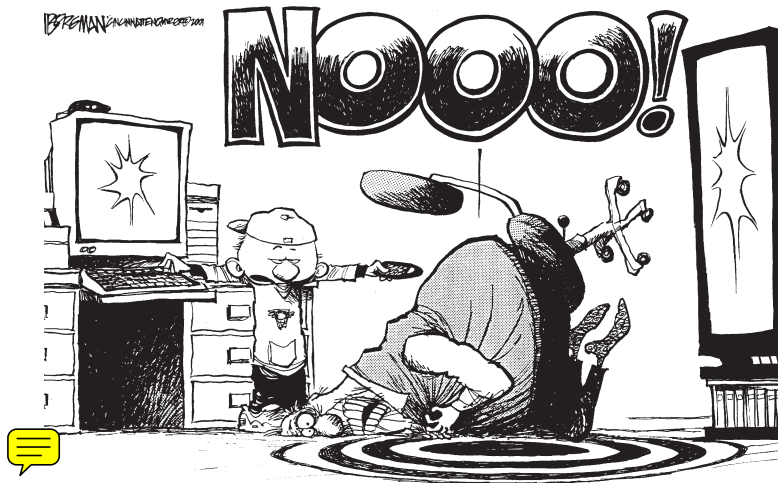
What's Fair?

Imagine an economy in which a dictator controls everything, keeping almost everything the economy produces for himself and allowing his subjects only the bare minimum they need to survive. Could such an economy be efficient?

Yes, it could. If there is no way to make one of the suffering citizens better off without making the dictator worse off, then the economy is efficient. But that doesn't mean we have to approve of it. The situation is clearly unjust. The contrast between the dictator's wealth and his subjects' poverty isn't fair.

This extreme example shows that we want something more than efficiency from an economy. We also want **equity**: we want the distribution of utility among individuals to be reasonably fair.

Equity means that the distribution of utility among individuals is fair.



"FAIR IS FAIR... IF IT'S TURN-OFF-YOUR-TV WEEK FOR ME, THEN IT'S UNPLUG-YOUR-E-MAIL WEEK FOR YOU."

But what exactly is "fair"? That turns out to be a very hard question to answer. To see why it's such a tricky question, let's consider how plausible ideas about fairness become problematic when you start to think about them carefully.

First, you sometimes hear that people should be given an equal chance at the starting line—that is, at birth, or maybe at the age of 18, everyone should have the same opportunities to be successful in life. That sounds fair—but what about the natural desire of parents to do well by their children? Shouldn't parents who own their own businesses have the right to appoint their children to executive positions in those businesses? Shouldn't parents who can afford to do so have the right to send their children to expensive private schools? It seems unfair that children of successful parents

should have an advantage over children whose parents don't have the same resources. Yet it would also seem unfair to prevent successful parents from helping their children. How do you resolve this contradiction?

Another familiar concept is that people should be rewarded for the work they do. And that, too seems reasonable: if you are a skilled worker, with twice my marginal product, it seems only fair that you should receive twice my wage. But what about someone who suffers an injury and cannot work? To say that that person should go without any income seems unfair.



The attempt to define fairness has led to some fascinating debates among philosophers. However, those debates have not led to any generally accepted definition.

Do we need a definition of *fairness*? Not necessarily—virtually everyone agrees that some outcomes, like our hypothetical dictator-dominated economy, are unfair, and in other cases we can agree to differ. But sometimes the lack of agreement on fairness means that economic analysis alone cannot be used to decide between alternative policies. To see why, let's introduce a new concept, the *utility possibility frontier*.



The Utility Possibility Frontier

Let's think of an economy that contains only two kinds of people, Easterners and Westerners. In Figure 13-6, the horizontal axis measures the total utility of the typical Westerner and the vertical axis measures the total utility of the typical Easterner.

An efficient outcome in this economy would be one in which there was no way to make either Easterners or Westerners better off without making members of the other group worse off. But there may be many such possible outcomes. In the figure we show what the possibilities might look like by drawing a **utility possibility frontier**, which shows how well-off each group *could* be given the economy's resources and the total utility of the other. Any point on the utility possibility frontier is efficient—that is, once you are on the frontier, the only way to make some people better off is to make others worse off. Any point inside the frontier is inefficient.

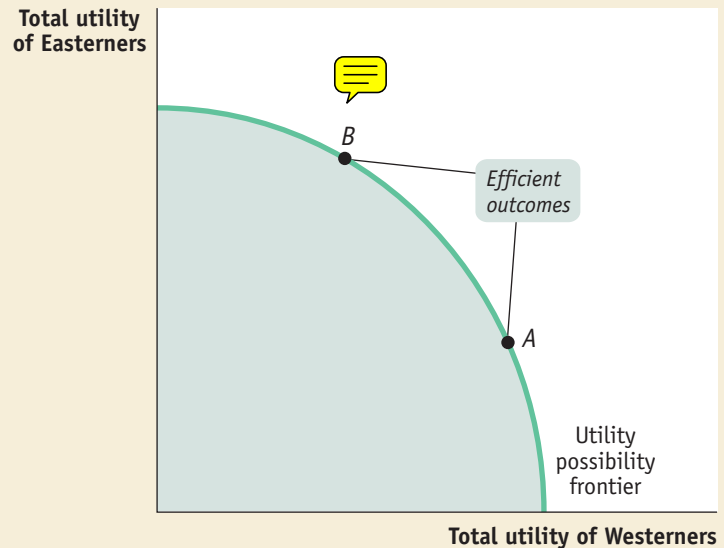
A **utility possibility frontier** shows how well-off one individual or group could be for each given total utility level of another individual or group.

So suppose that you were asked to choose between two sets of economic policies—one that would bring the economy to point A and one that would bring it to point B. For example, suppose there is a question of who should receive ownership of some disputed land. As long as the property rights are clearly defined, the economy will be efficient, but Westerners would prefer that they get the rights, and Easterners would prefer the reverse. So which outcome is better?

Figure 13-6

The Utility Possibility Frontier


The utility possibility frontier reminds us that there may be many efficient outcomes for an economy. The utility possibility frontier shows the maximum level of total utility of a typical Easterner, given the level of total utility of a typical Westerner. Any point on the curve is efficient because at such a point there is no way to make a typical Easterner better off without making a typical Westerner worse off, and vice versa. But this means that we cannot decide on economic grounds alone whether point A or B is better.





The answer is that it's a **matter of taste**. Westerners would, of course, prefer A; Easterners would prefer B. For government officials trying to decide how to assign the property rights, the answer **would depend on what relative weight they give to the welfare of the two groups**. The question of whether A or B is better is, in other words, a question of values that economics cannot answer.

Notice, by the way, that A and B don't differ just in how goods and services are distributed to individuals; they might well involve producing a different mix of goods and services. If Westerners like cornflakes but Easterners prefer shredded wheat, the economy probably produces more corn and less wheat at B than at A. Is it more efficient to produce corn or wheat? There is no answer to this question, because both can be efficient, depending on our goals.

The point that efficiency is a means to achieve goals,  not a goal in itself, can be further illustrated by considering what is wrong with *inefficient* policies. Figure 13-7 shows the same utility possibility frontier as Figure 13-6 but now also shows point C—an inefficient outcome, one that lies inside the frontier. **You might think of C as the result of a policy that favors Easterners in an inefficient way. In fact, many economists believe that the actual policies the newly reunited Germany followed to help the former East Germans were poorly designed, providing them with few incentives to take new jobs or acquire new skills. That is, many economists believe that Germany as a whole ended up at a point like C.**

Is there any reason why you might want to choose an inefficient point such as C? Not if better choices are **genuinely available**; there are points on the utility possibility frontier that are better than C whatever relative weight you give to the welfare of the two groups. For example, B is better than C by any standard.

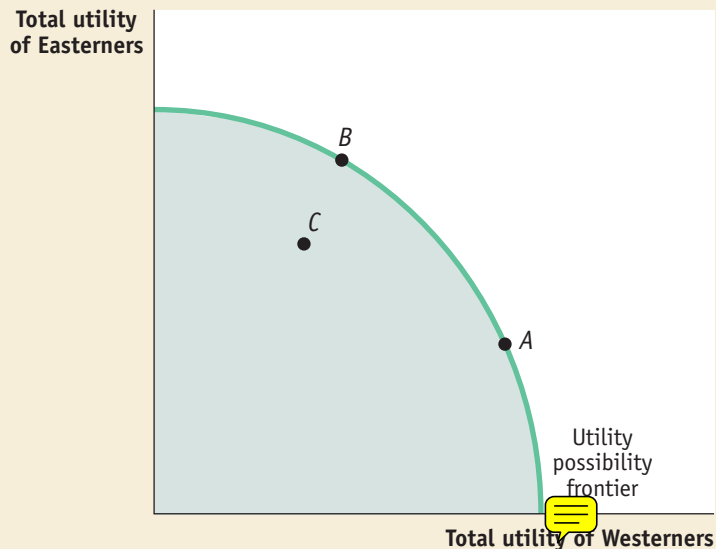


But what if the real choices are limited to A or C? Should you as a voter prefer the efficient policies proposed by the Western party?

Figure 13-7

Efficiency Versus Equity

Suppose that for some reason the policy choices that are available are restricted: you can choose only between the efficient outcome *A* and the inefficient outcome *C*. Does this mean that *A* is preferable? Not necessarily. If you place a high enough weight on the utility of Easterners, you may be willing to trade *efficiency* for *equity*: even though the economy is not efficient at *C*, the utility of Easterners is higher at *C* than at *A*.



Not necessarily. *A* is efficient, and *C* is not; but it is still true that Easterners are better off at *C* than they are at *A*. So if the utility of Easterners matters enough to you, you might well prefer *C* to *A* even though you would prefer *B* to either. As economists say, it is often—but by no means always—worth trading less efficiency for more equity.

So it's important to remember what efficiency is *not*. Efficiency is not a goal in itself, to be pursued at the expense of other goals. It is only a way to achieve our goals more effectively—whatever those goals may be. ■

