Opinion

Why Efficiency Matters...Even If You Value Equality

BY KARTIK B. ATHREYA

How do you judge whether the outcomes delivered by a market or another economic system are good or bad? One concept that economists use is Pareto efficiency. To understand Pareto efficiency, it is useful to first define a Pareto improvement. A Pareto improvement is a change in outcomes that leaves no one worse off and at least some better off. A Pareto efficient allocation, then, is simply one from which there are no Pareto improvements: To make someone better off, you would have to hurt another. Similarly, a Pareto inefficient outcome is one where Pareto improvements *can* be made.

Yet, some object to using Pareto efficiency as a guide for policymaking, in part because it does not place clear limits on inequality. And, in fact, there are many reasons why you might generally prefer a more even distribution of resources. First, and perhaps most obvious, inequality might strike you as ethically wrong. No person should be able to live off his riches while others have to labor long hours in difficult conditions just to get by, you might argue. Another objection involves social stability. You might claim that a society with considerable income inequality is unlikely to avoid internal conflict over the long run. In both cases, you might say that to reduce inequality you would be willing to give up a little efficiency.

In this column, I will suggest that efficiency is still a useful guidepost for economists and policymakers. First, inefficient outcomes are by definition unambiguously wasteful. Two or more parties could be made better off without hurting anyone else. Second, there are good reasons to believe that a substantial portion of observed inequality stems from inefficient trading arrangements. Therefore, improvements in the efficiency of markets — particularly those markets that help people insure against certain types of risks such as poor health or other events that may be difficult to foresee — would likely lower inequality *and* make all better off. As a result, there are important classes of situations in which there is no inherent trade-off between equity and efficiency. Third, over the long run inefficiency is the single biggest source of inequality. The most profound sort of inequality today exists *between* nations. Those countries that have pursued efficiency-enhancing policies are generally rich and those that haven't are not. Thus, trading efficiency for greater equality is not always as easy as it might seem.

Inefficiency can cause inequality more locally as well. Consider a tax on luxury boat purchases, with all revenues used to fund public expenditures for the poor. On the face of it, it sounds like if anyone will be hurt by this policy, it will only be a set of wealthy households who can afford to pay the taxes. The problem is that such taxes will reduce the number of luxury boat purchases in lieu of, say, luxury cruises, or some other activity that is a close substitute. This means that some boat workers will now have to search for new employers. And in the event that labor and equipment cannot be reallocated seamlessly, the consequences are potentially much larger. Therefore, inefficiency harms not just the rich, who either pay the tax or opt for a less-preferred option, but their trading partners as well, most of whom are not rich. Meanwhile, the revenues — and, hence, resources with which to make transfers — may not amount to much, since the demand for luxury items, such as yachts, is sensitive to price.

More generally, concerns about "fairness" or equality have led to many wasteful interventions — and *non*-interventions — in market function. For example, on the one hand, we often employ inefficient subsidies and forms of taxation, while on the other hand, we routinely fail to charge people for congesting roads or emitting carbon dioxide. Each of these policy choices either creates or abets inefficiency — and represents a foregone opportunity to make all of us better off. What's worse, in the cases where prices are hamstrung (for example, by rent controls), inequality may increase. Price-based allocation may be supplanted with "influence"-based allocation, and the latter almost by definition will favor the wealthy.

There is a better way. Competitive markets generally work well. Most of us are routinely able make the purchases and sales we plan on, at prices that we usually are not surprised by. A central result of economics is that under ideal conditions the outcome of trade in such settings will be efficient. And under realistic conditions, it is still likely to deliver a serviceable approximation for the allocation of many goods and services. This in turn suggests that we should focus public policy on efforts that fall into one of three categories: 1) those that remove the malfunctions in markets that can raise inequality, 2) those that do not directly alter prices in otherwise well-functioning markets, and 3) those that allow most people to gain from any given Pareto improvement. Efficiency and equality are not necessarily at odds; in the pursuit of the former, society may actually find that it has more of the latter. **RF**

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