12-16-2016

The Ethics Behind Efficiency

Jonathan B. Wight

University of Richmond, jwight@richmond.edu

Follow this and additional works at: http://scholarship.richmond.edu/economics-faculty-publications

Part of the Economics Commons

This is a pre-publication author manuscript of the final, published article.

Recommended Citation

Wight, Jonathan B., "The Ethics Behind Efficiency" (2016). Economics Faculty Publications. 50.
http://scholarship.richmond.edu/economics-faculty-publications/50

This Post-print Article is brought to you for free and open access by the Economics at UR Scholarship Repository. It has been accepted for inclusion in Economics Faculty Publications by an authorized administrator of UR Scholarship Repository. For more information, please contact scholarshiprepository@richmond.edu.
The ethics behind efficiency

Jonathan B. Wight

To cite this article: Jonathan B. Wight (2017) The ethics behind efficiency, The Journal of Economic Education, 48:1, 15-26, DOI: 10.1080/00220485.2016.1252294

To link to this article: http://dx.doi.org/10.1080/00220485.2016.1252294

Published online: 16 Dec 2016.
The ethics behind efficiency

Jonathan B. Wight

Department of Economics, Robins School of Business, University of Richmond, Richmond, VA, USA

ABSTRACT

The normative elements underlying efficiency are more complex than generally portrayed and rely upon ethical frameworks that are generally absent from classroom discussions. Most textbooks, for example, ignore the ethical differences between Pareto efficiency (based on voluntary win-win outcomes) and the modern Kaldor-Hicks efficiency used in public policy assessments (in which winners gain more than losers lose). For the latter to be ethically palatable, society must have in place basic institutions of justice, transparency, and accountability. Normative economics thus requires a pluralist approach that includes considerations of virtue and duty, closer to Adam Smith’s Enlightenment conceptions. This surprising finding should embolden economics teachers to engage students with critical thinking problems that are controversial and relevant, and which better prepare students for a complex world.

All that I had intended … was that [economists] might better realise the exact connection between the normative and the positive, and that their practice as political philosophers might be made thereby more self-conscious. Lionel Robbins (1938, 640).

In this article, I address a longstanding issue in economics: how should we evaluate economic outcomes and public policies? Lionel Robbins, who helped usher in the modern era of neoclassical economics, implores economists in the quote above to be more careful about the distinction between facts and values, and be more “self-conscious” about the use of normative elements disguised as science. This concern still applies today. Modern textbook writers strive to teach a fairly homogenous view of neoclassical microeconomics, one in which there is consensus on how economic welfare is defined, and generally use the term “efficiency” as if it were a scientific discovery, rather than a normative construction.

I seek to demonstrate first that discussions about efficiency and goals involve normative considerations; second, that students should be trained to consider multiple economic and social goals; third, that in discussing public policies many textbooks use the Pareto concept of efficiency when they should apply Kaldor-Hicks efficiency; fourth, that the moral defense of Kaldor-Hicks efficiency requires the existence of supportive institutions, and that the absence of such institutions limits the scope for normative analysis in certain contexts; and last, that considerations of duty and virtue ethics underlie the support of markets and policy-based efficiency recommendations.

Critical thinking by students about public policy would seem to require that they probe normative debates about how welfare ought to be measured, what version of efficiency is relevant to a particular policy question, and how non-consequentialist moral frameworks are needed to resolve some difficulties. Further, students should become adept at combining the best positive and normative foundations.
to arrive at recommendations for political economy. In short, adopting a pluralist approach engages students in important debates and may better serve the goals of a liberal education. Some of these arguments are developed more fully in Colander and McGoldrick (2009) and Wight (2015).

**Normative dimensions of Pareto efficiency**

Textbook writers have a Herculean task of covering many subjects, and nuances often must be omitted. At the same time, the basics should be covered clearly. One basic distinction that all textbooks address is between positive and normative economics. Yet, many texts fail to follow this distinction when presenting discussions about economic efficiency and public policy. Efficiency is a concept arising out of, and defended by, normative arguments. Calling something “efficient” requires that one place the highest value on a preselected goal, and such a choice is driven by values. Once a goal is selected, the determination of efficiency can entail scientific measurements. The scientific features should not obscure the normative nature of the undertaking.

In philosophy, teleology is the study of ends or purposes. In modern language, we simply call this outcome-based or consequentialist ethics. Economists as policy advisers are generally outcome-based ethicists because they focus on outcomes as the nexus of choice, both for individuals and policymakers. Within an appropriate normative context, this is a desirable and powerful approach. This method should be limited to situations in which the underlying institutional context is ethically defensible on non-consequentialist grounds, as discussed in later sections.

The discovery that failing to reach a market equilibrium can (under specific assumptions) result in “waste” is one of the premier findings of microeconomics. It is an astute insight that if an authority prevents the market from trading more than three units of a product (when equilibrium occurs at five units), this intervention produces a gap between what consumers would be willing and able to pay, and what sellers would be willing and able to sell, for marginal units. Allowing the sale of the fourth and fifth units would produce gains in what economists call the economic surplus, gains that in theory come at no cost to others provided that the market clearing price reflects true opportunity costs. The inability to carry out voluntary transactions in this circumstance produces a deadweight loss to both producers and consumers. This fact is noteworthy and important in the evaluation of public policies.

It is a short step from here to Pareto’s definition of efficiency, namely, a state in which all voluntary trades have been exhausted, and it is not possible to make anyone better off without causing involuntary harm to someone else. For illustrative purposes, Table 1 shows the results of surveying eight popular principles textbooks to see what they reveal about the treatment of efficiency and normative economics. In particular, the context in which efficiency is introduced is examined to see whether students are alerted to the normative aspects of this discussion. Every textbook but one defines efficiency in terms of Pareto efficiency (the exception is Colander, who presents efficiency more broadly as achieving desired ends). Five of the eight textbooks treat the subject of efficiency as a matter of science rather than one employing normative values.

<table>
<thead>
<tr>
<th>Textbook</th>
<th>Efficiency is positive or normative concept</th>
<th>Pareto efficiency</th>
<th>Kaldor-Hicks efficiency</th>
<th>Non-consequentialist ethics discussed</th>
<th>Smith’s moral sentiments discussed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baumol and Blinder, 13th ed.</td>
<td>Positive</td>
<td>Yes</td>
<td>No</td>
<td>Partial</td>
<td>No</td>
</tr>
<tr>
<td>Case, Fair, and Oster, 10th ed.</td>
<td>Positive</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Colander, 10th ed.</td>
<td>Normative</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Cowen and Tabarrok, 1st ed.</td>
<td>Mixed</td>
<td>Yes</td>
<td>No</td>
<td>Yes: Rawls</td>
<td>No</td>
</tr>
<tr>
<td>Hubbard and O’Brien, 4th ed.</td>
<td>Positive</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Krugman and Wells, 3rd ed.</td>
<td>Positive</td>
<td>Yes</td>
<td>No</td>
<td>Partial</td>
<td>No</td>
</tr>
<tr>
<td>Mankiw, 6th ed.</td>
<td>Positive</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Parkin, 11th ed.</td>
<td>Positive</td>
<td>Yes</td>
<td>No</td>
<td>Yes: Rule-based</td>
<td>No</td>
</tr>
</tbody>
</table>

Notes: Outliers are shown in bold. *See text.
It is not surprising that economics teachers are confused on this issue. Vilfredo Pareto and Arthur Pigou, who led the development of neoclassical welfare economics in the early twentieth century, were positivists who equated knowledge with empirical measurement. Economic welfare must therefore be “that part of social welfare that can be brought directly or indirectly into relation with the measuring rod of money” (Pigou 1962, 11). They tried to choose words that sounded scientific rather than value-laden to convey their ideas. Pareto, to avoid using “utility” coined the term “ophelimity” to represent relative satisfaction; Pigou preferred “desiredness” because “it cannot be taken to have any ethical implication” (1962, 11). Converting all welfare considerations into dollar equivalents imparts the “ring of factual propositions … [that] are likely to obscure the evaluations implied” (Bergson 1938, 327–28).

The promotion of efficiency as a scientific concept succeeded among many economics teachers, except those who opened up the hood to peer inside at the engine. David Friedman (1986, 347) noted that economists “claim to be positive scientists yet frequently use normative-sounding words.” Lionel Robbins (1981, 7) lamented that “the name conveys an impression of value-free theory which it should be just our intention to avoid.” Kenneth Arrow suggested that the confusion on nomenclature is deliberate because ultimately economists are interested in persuasion:

A definition is just a definition, but when the **definiendum** is a word already in common use with highly favorable connotations [efficiency], it is clear that we are really trying to be persuasive; we are implicitly recommending the achievement of optimal states (1963, 942).

As noted by McCloskey (1998), Coase (1994), and others, persuasion is an important feature of the way science progresses in practice, and thus the division between positive and normative economics is necessarily blurry.

The selling of efficiency as a scientific concept, rather than a normative one, arises from at least three misconceptions:

(1) **Settled consensus issue.** The consensus argument is that once a critical mass of economists agrees to adopt a particular version of welfare theory, it therefore becomes an “objective” part of the disciplinary canon. This is certainly true for debates about positive phenomena, such as why demand curves generally slope downward. Agreement on a normative issue, however, merely implies the existence of shared moral norms, and the implicit values operating out of view do not go away. A moral norm flying under the radar can be an impediment to critical thinking by students. Reinhardt (2010) noted, “[W]hen economists wax mushy on the virtue of what they call ‘efficiency,’ it is time to run for the hills, for they are selling a preferred moral doctrine in the guise of science.”

In *The Nature and Significance of Economic Science*, first published in 1932, Lionel Robbins promoted the idea of the positive/normative split. The science part of economics has to do with factual phenomena only, and Robbins makes clear in a later essay that this does not include welfare or efficiency considerations, which are “not warranted by anything which is legitimately assumed by scientific economics” (1981, 4–5). This does not preclude economists from analyzing the economic surplus and making ethical claims for its maximization. Indeed, Robbins said, “It is greatly to be desired that economists should have speculated long and widely on [normative and ethical] matters” (1945, 150). Such “political” economy is a necessary part of a liberal education that stresses critical thinking, as long as instructors are clear that they are doing a mix of positive and normative analyses.

(2) **Quantification is value-free.** While the dollar calculation of an economic surplus is value-free, it acquires importance only after economists add a normative interpretation: that economic behaviors reflect the rational pursuit of preference satisfaction, that satisfying preferences enhances human welfare, and that the goal of an economic system is to maximize welfare defined as preference satisfaction. Such evaluations require both facts about the surplus and explicit values that place preference satisfaction over other economic goals.

Quantifiability is not a unique attribute of efficiency theory. Alternative “objective” calculations relating to human welfare have been constructed, such as the Human Development Index (HDI) or the Gini coefficient of inequality. If economists present information on the size of the economic surplus as *one*
factor affecting economic welfare, that is quite different from asserting that (by definition) the economic surplus is synonymous with economic welfare.

For many of the reasons elaborated above, Amartya Sen argued that economic efficiency is an incomplete and therefore superficial measure of evaluation. He noted that "an economy can be optimal in [the Pareto] sense even when some people are rolling in luxury and others are near starvation. ... In short, a society or an economy can be Pareto-optimal and still be perfectly disgusting" (1970, 22). By judging economic performance only on the basis of dollar votes cast, economists operate in a "barren informational landscape" (Sen 1995, 7).

(3) Specialization justifies ethical myopia. A final misconception is that economists have little to say about ethics and can ignore the subject, confident that the normative consensus about efficiency is all an economist need know. David Friedman (1986, 347), for example, argued that:

As an economist, I have no expertise in good and bad. I can, however, set up a “criterion of goodness” called efficiency. ... One could object that the economist, defining efficiency according to what questions he can answer rather than what questions he is being asked, is like the drunk looking for his wallet under the streetlight because the light is better there than where he lost it. The reply is that an imperfect criterion of desirability is better than none.

Friedman rightly noted the “imperfect” nature of this criterion and its normative foundations, and would presumably be open to thoughtful deliberation and debate, even though he claimed to have no expertise. As noted earlier, the economic (scientific) point of view was not meant to stifle ethical discussion because moral discourse is vital for public policy analysis. Robbins insisted that “[b]y itself economics affords no solution to any of the important problems of life. I agree that for this reason an education which consists of [positive] economics alone is a very imperfect education” (1945, 9).

It is also incorrect to argue that economists have little to learn from or contribute to the study of ethics or human welfare, given the large number of Nobel Prize winners in economics who have explored such topics (a partial list would include Samuelson, Arrow, Myrdal, Hayek, Friedman, Simon, Buchanan, Solow, Coase, Fogel, Selten, Harsanyi, Sen, Stiglitz, Kahneman, and Ostrom). It may be more accurate to say that many economists need help in learning the tools of ethical analysis. Adam Smith, who promoted the advantages of specialization, also noted its main defect, that it promoted ignorance (1776/1981, 506). Robbins’ quote at the start of this article seems applicable, that economists should be more self-conscious about their use of normative concepts. Efficiency remains a normative concept despite attempts to portray it as science, and notwithstanding the lack of awareness as to its ethical foundations. For elaboration of these issues, and the ones below, see Hausman and McPherson (2006) and Wight (2015).

Multiple economic outcomes

In light of these considerations, a possible way for teachers to proceed is to draw students into this debate, pointing out that any evaluation of outcomes involves a mix of positive and normative elements, and that the preference satisfaction view of efficiency is one of several bits of evidence about well-being. This approach is pluralist, getting students to recognize that more than a single outcome measure is needed to understand human well-being. It also recognizes that efficiency should always be understood within a wider normative framework of policy analysis.

For example, students may wish to examine cases in which satisfying preferences might cause a fall in welfare (think of the drug addict), preferences may be polluted through advertising, consumers may not always be rational, or other gaps in the standard welfare model. These are important topics within the “political economy” framework envisioned by Robbins, and they generate classroom excitement that enhances critical thinking. One example would be to ask students to evaluate the attempt by the New York City Board of Health to ban super-sized soft drinks, which relies on the claim that consumer welfare is improved when choice options are reduced.

One textbook ancillary that promoted such a pluralist outcomes-approach was by Rendigs Fels and Stephen Buckles, Casebook of Economic Problems and Policies: Practice in Thinking (1981). The authors take it as de rigueur that critical thinking requires that students in each and every case explore the multiple
kinds of outcomes produced by public policies. Ultimately, students must rely on their own normative values as to whether the goal of efficiency trumps other worthy goals in policy evaluation. A similar approach is found in the “prudent pragmatism” of William Bluhm and Robert Heineman in *Ethics and Public Policy: Methods and Cases* (2007).

Virtually all principles textbook writers admit that there are other economic goals that count besides maximizing the economic surplus, such as equity, growth, stability, freedom, and so on. Often, textbook writers switch between goals without even recognizing that doing so requires changing the normative standard by which outcomes are evaluated. For example, textbooks typically report that market competition generates efficient outcomes under the right circumstances. When discussing monopoly, however, textbook authors approvingly discuss patent protection that promotes innovation and discovery. Endorsing a patent monopoly involves a normative thought process that goes something like this: innovation is good because it provides consumers in the future with better products and services, satisfying preferences that do not exist in the present. The deadweight losses generated by a patent monopoly hurt current consumers, but the expected gains to future consumers should be weighted more heavily than current losses, even though there is no scientific basis by which to calculate what future consumers will gain (because these products do not even exist). A patent monopoly is thus justified not by the Pareto efficiency test, but by faith in the setting of rules that may, over the long course of history, produce good results. The moral framework is “rule consequentialism” rather than “act consequentialism,” and the goal is dynamic efficiency rather than static efficiency.

What moral argument justifies privileging future generations over the present generation in this way? This is not a matter of science but of ethics. Becker and Elias (2007), in analyzing a proposal to create a market for kidney transplants, similarly changed the normative goal from one of static efficiency to one of saving the most lives, without discussion or defense. If it is acceptable to pick and choose goals without debate, this should reinforce the notion that efficiency cannot be a purely scientific concept, but belongs firmly in the realm of normative political discourse.

Still, textbook writers seem wedded to the notion of efficiency as a purely positive technical concept. Frank and Bernanke admitted that “efficiency is not the only goal” in society, but they nevertheless assert, as if it were scientific truth, that “efficiency should be the first goal” of public policy, because being economically efficient “enables us to achieve all our other goals to the fullest possible extent” (2009, 179, emphasis added). The claim that efficiency is in fact the only good outcome seems to rely on a magical alchemy that can transform the economic surplus into any other desirable outcome at no cost. Likewise, Krugman and Wells stated that “what is important for economists, however, is always to seek to use the economy’s resources as efficiently as possible in the pursuit of society’s goals, whatever those goals may be” (2012, 15, emphasis added).

Is “efficiency” as economists define it always desirable in the pursuit of other goals? The answer is perplexing because the different aspects of efficiency may clash with other goals of society. Laws that require truck drivers to take mandatory rest breaks reduce the productive efficiency of motor carriers (miles driven per hour of labor input) yet serve the goal of public safety. Likewise, laws banning child labor in mines raise production costs. Safety and productive efficiency cannot both be prioritized; in other words, society sometimes lowers productive efficiency in order to achieve other goals. It is impossible to even identify a production possibility frontier curve without first considering the institutional and moral context under which production takes place (e.g., the Fair Labor Standards Act of 1940 mandates a 40-hour workweek). These are relatively easy points for teachers to address by noting that we should strive for productive efficiency within the changing institutional rules of society (Colander 2017, 29).

The problem of maximizing allocative efficiency “whatever” the other social goals may be is not so easy to overcome. A doctor swears a Hippocratic oath to put patient interests ahead of all other interests. Typically, this implies saving the most lives possible given scarce resources. Suppose a doctor has a limited supply of blood that could be used to save the lives of two children, or alternatively, to save the life of one elderly billionaire. What should the doctor do? Saving the most lives (or most life-years extended) would dictate using the blood for the children. Allocative efficiency does not mean “saving the most lives” but rather putting resources to the use of people who value them most. This means
using the blood for the billionaire who bids up the price. Medical efficiency and economic efficiency are not complementary goals in this short-run example because distributional considerations matter. In *A Critique of Welfare Economics* (2002), Ian Little argued that for any policy change to be labeled as welfare-enhancing, a necessary condition should be that it produce a not-unfavorable redistribution of income.¹

To summarize, arguing that economic efficiency automatically “enables us to achieve all our other goals to the fullest possible extent” fails to properly distinguish between normative goals and the tradeoffs that exist. The Case, Fair, and Oster textbook addressed this appropriately:

> In talking about general equilibrium in the beginning of this chapter, we continue our exercise in *positive economics*—that is, we seek to understand how systems operate without making value judgments about outcomes. Later in the chapter, we turn from positive economics to *normative economics* as we begin to judge the economic system. Are its results good or bad? Can we make them better? In judging the performance of any economic system, you will recall, it is essential first to establish specific criteria by which to judge (2012, 254).

They further noted that “economists who ask explicitly normative questions should be required to specify their grounds for judging one outcome superior to another” (2012, 10).

**Efficiency and public policy**

**Kaldor-Hicks efficiency**

The Pareto version of efficiency is rarely of use in public policy debates for the well-recognized reason that changes to existing institutions or policies always cause harm to some, making Pareto improvements impossible. In the 1930s, Nicholas Kaldor (1939) and Sir John Hicks (1939) attempted to resolve the Pareto problem by reformulating the definition of welfare. Instead of the goal being the actual satisfaction of consumer preferences, the new goal became the *capacity* to satisfy consumer preferences. In this rendition, not everyone must gain from a policy change, as long as the winners gain more than the losers lose. While compensation to losers is a theoretical possibility, Hicks noted that this rarely happens in practice:

> Every simple economic reform inflicts a loss upon some people; the reforms we have studied are marked out by the characteristic that they will allow of compensation to balance that loss, and they will still show a net advantage. Yet when such reforms have been carried through in historical fact, the advance has usually been made amid the clash of opposing interests, so that compensation has not been given, and economic progress has accumulated a roll of victims, sufficient to give all sound policy a bad name (Hicks 1939, 711).

He further stated:

> I do not contend that there is any ground for saying that compensation ought always to be given; whether or not compensation should be given in any particular case is a question of distribution, upon which there cannot be identity of interest, and so there cannot be any generally acceptable principle (Hicks 1939, 711).

Compared to Pareto’s approach, the Kaldor-Hicks version of efficiency involves government *coercion* (threatening to punish economic agents if they do not conform) or *compulsion* (using force to compel particular actions). In both cases, losers from a policy change are not voluntarily choosing the policy change. What are the reasons or circumstances in which it is morally acceptable to force others to take an action against their own wills? This is a difficult topic in moral philosophy, and surely beyond any concept of positive science. Robbins, previously cited, honed in on this problematic aspect: “Thus both as regards utility and liberty we are eventually involved in questions relating to the coercive powers of government and the basis of consent” (1981, 9).

> There are many ways of addressing this in class, such as through playing a John Rawls’ Game, in which students explore how institutional rules or policies could arise behind “the veil of ignorance” (Wight and Morton 2007, 161–76). This is not to endorse Rawls, because there are noted weaknesses in this approach, but the experience gets students thinking about the important issue of voluntary consent. Another approach that takes little time is to quiz students about what they think are the moral justifications for the existence of a state and for citizens to provide their consent to being governed. What evolves
might be something like this: one gives voluntary consent to being part of a social compact, believing that bound together there will be welfare and security gains that over the generations, will make it worthwhile.

One example to use in class is the Mayflower Compact, an agreement signed in 1621 by early settlers to Massachusetts facing famine and other calamities. On the eve of going ashore they agreed that they:

Do by these presents solemnly and mutually in the presence of God and one of another, Covenant and Combine ourselves together in a Civil Body Politic, for our better ordering and preservation and furtherance of the ends aforesaid; and by virtue hereof to enact, constitute and frame such just and equal Laws, Ordinances, Acts, Constitutions and Offices from time to time, as shall be thought most meet and convenient for the general good of the Colony. (Plimoth Plantation n.d.)

In making a social compact, one acknowledges that some of the time one might be required to do things one would prefer not to do, but this is acceptable provided there are basic institutional guarantees of individual rights. Governments use coercion (the threat of force) all the time to achieve policy goals, such as in maintaining law and order and reducing crime. Intimidating crooks is done to promote greater freedom for most other citizens. Even so, a criminal has inviolate rights, such as to a fair judicial process, a trial by peers, no self-incrimination, no cruel punishment, and so on. Hence, the justification for coercion and compulsion does not rest solely on the good outcomes that are envisioned; it is intricately bound up with rules and duties and the process by which the rules of coercion and compulsion are derived and implemented.

Using this line of reasoning, one could argue that coercion as an economic policy tool can be ethically justified in certain institutional contexts, say if we are living in a democratic society with a fair legal system, clear property rights, low transactions costs for defending property rights, and basic rights of assembly, free speech, and so on. Kaldor-Hicks efficiency and the compulsion it implies is a difficult concept to defend in many parts of the world where these institutional preconditions are tenuous or nonexistent. This would not be news to economists trained in earlier generations. Here is how Frank Knight put it:

It is well to state explicitly at the outset that the society considered in this essay is the sovereign democratic state, that is, a modern Western nation, where law is made and enforced by a responsible government within the context of representative institutions (1960, 19).

By the late twentieth century, however, more and more students have been taught that economic efficiency is a scientific construct, applicable as physics or mathematics to any society anywhere in the world. Lant Prichett, working under Chief Economist Larry Summers at the World Bank, wrote an ironic (and ultimately embarrassing) memorandum that illustrates the problem with this belief. Using standard efficiency reasoning, Prichett sarcastically proposed that polluting factories in the United States should be outsourced to poorer countries in Africa. Because both incomes and life expectancies are lower in that region, “the economic logic behind dumping a load of toxic waste in the lowest wage country is impeccable and we should face up to that” (cited in Hausman and McPherson 2006, 12–13).

The logic is indeed impeccable, but the normative social compact that would justify coercion and compulsion has not been examined. Some people in Africa would be involuntarily harmed, even as others gain jobs and higher incomes. How are the injured to seek redress? Many African citizens have little voice to give consent due to limited property rights, they cannot vote in fair elections, and they cannot make good judgments about environmental risks and costs because of the censored flow of information in public media. No independent judiciary is available to address grievances, and those who protest such a rigged system face intimidation and violence. In short, the ethical justification for harming some citizens to generate higher rewards for others rests on institutional foundations that are questionable in many parts of world. Summers later apologized: “When I make a mistake, it’s a whopper” (Rosenberg 2001).

**The Kelo case**

Even if compensation is paid, consent may still be absent. There are various possible reasons for this. Consider the famous *Kelo vs. New London* case, in which Suzette Kelo’s Connecticut home was taken without consent for a private development project. Ostensibly, the land was more valuable to a private developer than it was to Kelo, but a win-win voluntary trade did not occur. Rather, the city government
intervened using the power of eminent domain to force a sale in the interests of what planners thought would be a Kaldor-Hicks improvement to welfare.

Kelo might have been holding out selling for strategic motives, or she may have other reasons that the standard economic evaluation of compensation cannot address. For example, she may value the house more than its market value for sentimental reasons, or she may have made commitments (e.g., a promise to keep the house in the family [White 2009]). James Buchanan doubted that cost-benefit calculations based on coercion can be meaningful because opportunity costs cannot be measured as Kelo herself would subjectively assess them. Any estimates of efficiency gains from coercion “must remain almost wholly arbitrary” (Buchanan 1999, para. 6.5.4). Despite the uproar over this case, one can at least argue that Kelo enjoyed the right of appeal to a higher court, with presumably fair judges; Kelo lost that appeal, 5–4, at the U.S. Supreme Court in 2005.

Textbooks and Kaldor-Hicks

With few exceptions, however, textbooks glide into discussing public policy as if the Pareto efficiency standard applies. That is, students are taught that efficiency means Pareto efficiency, but then they are given examples of public policies that would clearly entail involuntary harm to some. Out of the eight textbooks examined in table 1, none explicitly mentioned Kaldor-Hicks by name, but two texts discuss the idea behind it. Case, Fair, and Oster noted:

If some gain and some lose as the result of a change, and it can be demonstrated that the value of the gains exceeds the value of the losses, then the exchange is said to be potentially efficient. In practice, however, the distinction between a potentially and an actually efficient change is often ignored and all such changes are simply called efficient (2012, 258).

This may well be a common practice among instructors: ignoring coercion entirely or through omission, pretending that outcomes are the same regardless of whether compensation is paid or not. Mankiw, for example, stated without reservation or qualification that “trade can make everyone better off” (2012, 10, emphasis added). He was clearly thinking about Pareto optimal voluntary trade between individuals, but immediately applied the concept to the study of international trade. This is bait and switch, in terms of moral arguments. He drew a normative conclusion relying on the Pareto standard, which is not the relevant efficiency measure to apply when assessing policies that involve losers. Kaldor-Hicks is the proper standard in this case, and calls on an analysis of normative dimensions that are contextual and require discussion and debate.

Krugman and Wells, by contrast, stated that “there are gains from trade,” which is subtler and does not assert that the effects of trade are all positive or that the gains exceed the losses (2012, 12). When Cowen and Tabarrok discussed the merits of trade intervention, they queried the student and drew on critical thinking about ethics: “Is a sugar quota a good policy? That depends on what we think is good and who we think counts most when we measure benefits and costs.” They continued, “Economics has limitations and you need to know what they are. It helps to know which ethical values are left out of economic theory” (2010, 366). Cowen and Tabarrok also provided an institutional emphasis, noting that good institutions are needed to align self-interest with social interest (2010, 2). This gets to the heart of the difference between Pareto efficiency and Kaldor-Hicks efficiency; these authors also provided a short chapter on ethical theory.

In the textbooks reviewed in table 1, five out of the eight at least partially considered non-consequentialist considerations, and three did not. Generally, however, Sen’s critique seems relevant: “The violation or fulfillment of basic liberties or rights tends to be ignored in traditional utilitarian welfare economics. … [N]o direct and basic importance is attached in the utilitarian framework to rights and liberties in the evaluation of states of affairs” (1995, 2).

Non-consequentialist considerations

We have already noted that the ethical justification for Kaldor-Hicks relies not just on outcomes, but on institutional rules and processes. The shift from outcome-based ethics to rule-and-duty-based ethics needs elaboration. A quick example suffices: one popular sports slogan says, “Winning isn't
everything—it’s the only thing.” By this measure, the final score is the sole measure of success, but outcomes are not the only thing that matter, or that motivate peoples’ actions. If outcomes were the only thing that mattered, everyone would be an opportunistic thief, stealing whatever they desire whenever the coast is clear. Judges would sell their decisions, and police would always take bribes if they thought they could get away with it (Arrow 1972, 357). If this statement rings hollow, then the non-consequentialist, duty-based view bears consideration. As White noted, “People ignore their preferences, or sacrifice their wellbeing, for principles every day” (2009, 57).

A counter-slogan thus says, “It’s not whether you win or lose, it’s how you played the game.” Referees try to make the outcome defensible by enforcing rules, and the rules impose duties or obligations on players who often act on the basis of such principles. Milton Friedman demonstrated the concern for principles and duty when he exhorted corporate leaders to maximize profits on behalf of shareholders (Calkins and Wight 2008). In the right circumstances, profit-maximization leads to efficient resource allocations in competitive markets. CEOs, who have better information than the firm’s owners, can manipulate short-term earnings so as to receive higher bonuses, or can make extravagant corporate charity donations so as to win public acclaim (the so-called “principal-agent problem”). Friedman argued that CEOs have a fiduciary duty not to act out of their own self-interests but out of obligation or duty to shareholders. Friedman’s defense of market outcomes relies on individuals following non-consequentialist ethics.

Aside from the Ten Commandments, the strongest philosophical principles for duty ethics come from Immanuel Kant and his categorical imperatives: first, to not make an exception of yourself (your actions should be universalizable), and second, to treat all others not merely as means to your ends, but as ends in themselves. In this light, the Pareto test for efficiency relies on Kantian ethics to the extent that it endorses no particular outcome, but rather supports the process by which individuals are allowed to voluntarily trade. This process treats individuals as autonomous moral agents who are granted equal dignity with every other and whose choices are not second-guessed. Pareto optimality is grounded in the categorical imperative to treat economic agents with respect. Likewise, institutions of justice that buttress the market must be populated with people who adhere to duty ethics, leading Arrow to argue that for the price system to work well, a parallel Kantian system is needed to “supplement” it:

The price system is not, and perhaps in some basic sense cannot be, universal. To the extent that it is incomplete, it must be supplemented by an implicit or explicit social contract. Thus one might loosely say that the categorical imperative and the price system are essential complements (1972, 347).

Why should any CEO obey the call to put shareholder interests first? The indispensable need for self-restraint or commitment to duty is notably lacking in neoclassical economics. Adam Smith, however, devoted his first book, The Theory of Moral Sentiments (1759/1982), to deriving a model to explain how and why economic agents can also be moral agents, that is, who in appropriate circumstances constrain their own gains so as to fulfill obligations to others. Self-interest is embedded within a social and moral framework, and individuals learn over time what is appropriate. Self-control that is internally derived by learned principles (not based on external rewards) leads to a grounding in virtue-ethics. Ambition and striving are commendable, within the scope of one’s obligations to others.3

The relevance of Smith’s virtue ethics should be clear. Kaldor-Hicks can be justified only by the existence of appropriate institutions. For rules of justice, or government, or academic science to work well, individuals who enforce the rules must themselves abide by non-consequentialist duty ethics, upheld by individual virtue. In justifying Kaldor-Hicks, it is not enough to have appropriate institutions on paper if the people who enforce the rules are corrupt. Given the spurt of research on and popularity of Smith’s Theory of Moral Sentiments (TMS) (1759/1982) over the past two decades, teachers and students should be aware that the “invisible hand” of the market is not synonymous with “greed is good,” because economic actors bring self-control to their behaviors, not simply from a consideration of outcomes, but from principles of virtue and duty (Wight 2007). Only one of the eight textbooks reviewed in table 1 mentioned TMS as a foundation for understanding the workings of markets or the invisible hand.

If students are to be trained as policy advisers, they should be above suspicion that their recommendations are tainted by personal interests, for ethical duties also apply to economists. Two recent texts highlight the relevant issues, DeMartino and McCloskey’s The Handbook of Professional Economic Ethics
Another way of saying this is, normative issues arise in the study of positive economics, and vice versa, leading Samuelson to declare that “the distinction between is and ought, between objective and subjective issues, [is] at bottom a matter of degree rather than kind” (1976, 633). This line of inquiry leaves us with David Colander’s longstanding complaint that the positive-normativesplitisanartificialconstructthatgetsinthewayofthinkingseriouslyaboutpolicy (Colander 1992). The “art” of doing applied economics involves a third category, not purely scientific, not purely normative, but a careful blending of ideas needed for crafting policy solutions. The insights from positive analysis, along with the judgments or goals from normative theory, come together in the formulation of nuanced policy options. Such a political economy approach has a long tradition in economics (Colander and Su 2015), and provides a framework for resolving issues raised in this article about institutions and the use of the Kaldor-Hicks efficiency standard.

Conclusions

In the eighteenth century, three Enlightenment philosophers provided us with differing moral frameworks of analysis. Jeremy Bentham proposed outcome-based utilitarianism, Immanuel Kant proposed duty-based ethics, and Adam Smith proposed virtue-based ethics. In this article, I have sought to demonstrate that while economists generally work in the realm of outcome-based ethical analysis, it is not easy to make sharp distinctions. In particular, Pareto efficiency relies on a moral claim to treat people with respect and allows them autonomy to make their own choices. This sounds a lot like Kantian ethics, although some Kantians might disagree (White 2009).

I also demonstrate that the moral defense of Kaldor-Hicks efficiency relies on the existence of appropriate institutions and people to enforce the rules who adhere to duty and virtue ethics. The defense of efficiency thus involves a pluralist approach, considering the relevance of all three ethical frameworks: a particular policy promises to produce desirable outcomes (e.g., increase the economic surplus), and those who are harmed by the policy have institutional rights that protect their interests, and those entrusted with overseeing these institutions will enforce the rules with only minor prejudice or corruption.

Exploring the normative foundations of efficiency offers the promise of enhancing critical thinking. Public policy issues traverse the boundaries of academic disciplines and raise important ethical questions. If economists maintain that efficiency is simply a “fact” instead of an evaluative construct, it creates intellectual blinders for students doing public policy work. Well-trained students in economics “should be able to scrutinize the moral underpinnings of a policy statement,” which is not possible if they believe that efficiency is simply the technical procedure of adding up numbers (Atkinson 2001, 204). Amartya Sen, who led the resurgence of interest in ethics in economics, argued that “an economic analyst ultimately has to juggle many balls, even if a little clumsily, rather than giving a superb display of virtuosity with one little ball [e.g., efficiency]” (cited in Klamer 1989, 141).

The main point of this article is that the attempt to present economics as a settled science (rather than as a robust, changing, controversial, and exciting conversation that includes moral analysis) is a disservice to students. It is not necessary that students be treated as incapable of dealing with nuance and ambiguity. Paul Samuelson’s Economics textbook was a bestseller for decades. When discussing the impacts of government intervention, Samuelson noted, “Naturally, all this is a controversial area. There is no one answer” (1976, 399). The following conclusion is drawn:

The reader is warned that all the above issues of welfare economics can be given varying interpretations and can lead to controversial debate which cannot be presumed to be settleable within positive science. … Economic science arms one for the great debate; it does not preclude that debate or prejudice its conclusions (Samuelson 1976, 635).

Colander, mentioned earlier, supported this caution and noted that “the art of economics is contextual and as much dependent on non-economic political, social, institutional, and historical judgments as it is on economics.” Once this is made clear to students, many controversial disagreements (e.g., about the desirability of the Trans-Pacific Partnership Treaty) are seen to “result primarily from different judgments.
about political and social dimensions of policy implementation, not about differences in underlying theory” (1992, 197).

The political economy approach involves the careful study and joining of positive with normative elements to make policy suggestions. If this were implemented, what teachers would address with students about policy matters would be richer in terms of context, clearer in terms of normative values, and humbler in terms of final prescriptions. The claim is that this better prepares students for the ambiguity and complexity of the world they will come to inherit.

Notes

1. This claim may be too stringent, but its virtue is that it would force policy analysts and students to consider multiple outcomes.
2. It is important to point out that only adult males were allowed to sign the agreement, and adult women and some adult servants did not participate. Would such a compact with unequal participation be considered ethically defensible today?
3. Hence, an entrepreneur "may run as hard as he can, and strain every nerve and every muscle, in order to outstrip all his competitors. But if he should justle, or throw down any of them, the indulgence of the spectators is entirely at an end. It is a violation of fair play, which they cannot admit of" (Smith 1759/1982, 83).

Acknowledgments

The author is grateful for spirited conversations on these issues with Robert Dolan, Erik Craft, David George, George DeMartino, Rob Garnett, John Davis, Mark White, Irene van Staveren, and members of the Association for Social Economics. David Colander also provided valuable suggestions for the article.

References


