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Insufficiency of Efficiency

Sound Bite

Efficiency is an important goal of the economy, but it is not the only goal. In fact, efficiency comes in third place behind sustainability and justice as economic priorities. What's the use of an efficient economy if it can't provide fair distribution over the long term?

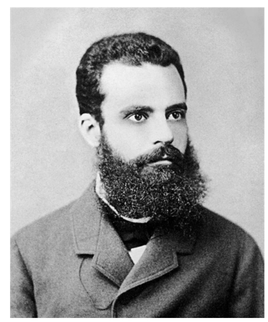
Misplaced Faith in Efficiency

In economics, the term efficiency refers to the efficient allocation of resources (see sidebar). Most mainstream economists have elevated efficiency to the top of the heap of priorities, based on a misconception. Economists have attempted to portray economics as an objective, value-neutral field of study, like physics or chemistry. In doing so, they have emphasized efficient allocation of resources as a value-neutral method for maximizing human well-being. The problem is that the economy is not value-neutral! It is a human-built institution, and the rules that govern it affect people and the planet in all sorts of ways that reflect societal values. Well-being depends on much more than efficient allocation of goods and services. It is entirely rational to strive for efficient allocation, but not as the primary or even secondary concern of the economy. An all-out emphasis on efficiency does not account for more important goals of the economy, namely (1) the ability of economic institutions and activities to be sustained over the long run, and (2) fair distribution of wealth and income.

Efficiency and Scale

Efficient allocation is not helpful in making sure the economy fits within the capacity of the ecosystems that contain it. If ecosystems were unlimited and invincible, and economic activities stood no chance of undermining them, there would be no need to worry about the size of the economy. But the negative impacts of economic activities on ecosystems are irrefutable. It is as much the scale of our activity as it is the type of activity that threatens environmental health. Being more efficient at an unsustainable scale is still not sustainable.

Pareto Efficiency



Italian economist Vilfredo Pareto (1848-1923) defined efficiency as most economists understand it today. Pareto efficiency means that resources are allocated in such a way that no individual can be made better off without making someone else worse off.

In economic theories and abstract models, transactions are typically construed in simple terms, but in the real world, they are complex and come with spillover effects. The criterion used for actual decision making is thus *potential* Pareto efficiency, which only requires that the gains from a transaction be large enough to compensate those harmed. Potential Pareto efficiency does not require that compensation take place; it simply must be theoretically possible!

Efficiency and Distribution

To allocate resources through a market, through governmental action, or any other means, there first has to be understanding about who owns and has access to the resources. If ownership and access are unfair, then efficiency doesn't go very far in making people's lives better. For example, compare two economies, one in which the king expends 99% of total resources on luxury items while his subjects starve, and one in which resources are distributed fairly and all live well. The allocation of resources in both economies may be efficient (no one can be made better off without making someone else worse off), but wellbeing and satisfaction with life are much improved in the second economy. Efficiency takes no account of justice; efficient allocation by itself cannot generate the best economic results.

Desirable Ends Matter

Crack cocaine is a huge industry in the USA and one that routinely wrecks lives. Crack was invented in the mid-1980s by cocaine producers pursuing higher efficiency; they wanted more profit from less substance. Drug dealers continue to experiment with product innovations, coordination, and marketing to increase the efficiency of their trade.

One wishes that the producers and pushers of crack were less efficient! This is example is not meant to be insensitive or overly dramatic, but to illustrate the insufficiency of efficiency as a framework for evaluating policy. The desirability of efficiency depends on the goals. A job not worth doing is not worth doing well.

Limitations of Efficiency

There are several problems with emphasizing efficiency. First, achieving efficiency is only useful when applied to a desirable goal (see sidebar). Second, efficiency can trigger perverse outcomes. For example, the development of more efficient engines has caused more, not less, consumption of fossil fuels. Third, increasing scale in the economy can swamp the positive effects of more efficient production practices. For instances, even though we require less energy to produce a dollar's worth of output than we did a decade ago, we are using more total energy, because of the growth of the economy.

Efficiency in the Steady State

In a steady state economy, efficiency is an important (but not overriding) goal. Economic activity is evaluated by the following criteria, in order:

1. Sustainability of scale
2. Justice of distribution
3. Desirability of goals and outcomes
4. Efficiency in allocation

Sources

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