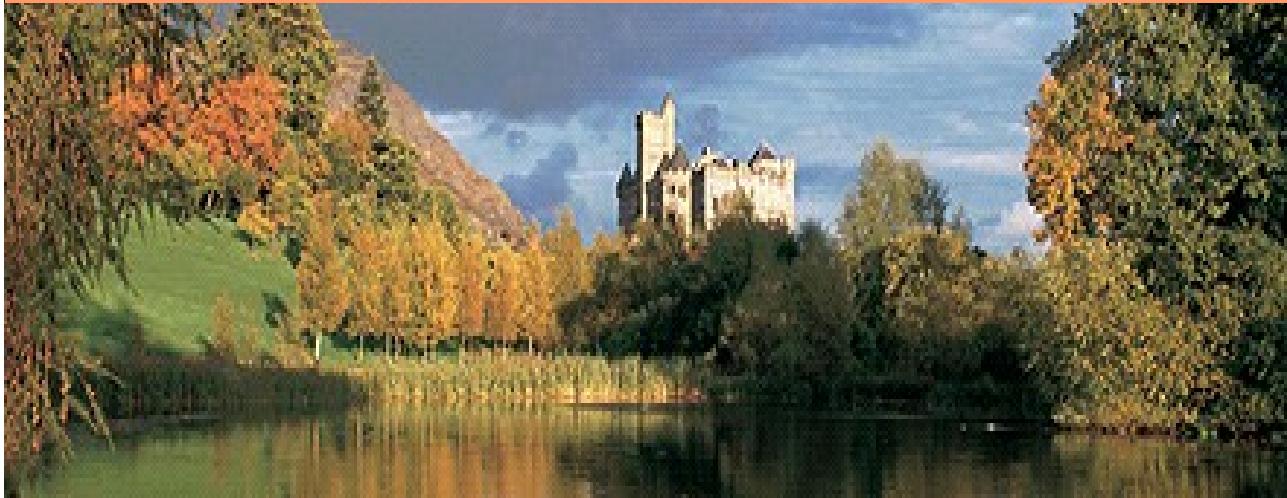


# ***SCEME Working Papers***

Advances in Economic Methodology



The ethics of efficiency

*Irene van Staveren*

SCEME Working Paper No. 18  
2007

SCEME Working Papers are sponsored by the Stirling Centre for Economic Methodology <[www.sceme.stir.ac.uk](http://www.sceme.stir.ac.uk)>. The purpose of the series is to offer economic methodologists an online repository for disseminating work in progress at a pre-publication stage in order to facilitate peer discussion. The series can be accessed at [www.sceme.org.uk](http://www.sceme.org.uk), and is also listed in RePEc <<http://ideas.repec.org/s/sti/wpaper.html>>.

## IMPRESSUM

Editor: Matthias Klaes <[mk@sceme.org.uk](mailto:mk@sceme.org.uk)>

Editorial Board: Brian Loasby <[b.j.loasby@stir.ac.uk](mailto:b.j.loasby@stir.ac.uk)>  
Sheila Dow <[s.c.dow@stir.ac.uk](mailto:s.c.dow@stir.ac.uk)>

ISSN 1756-2031

Submissions to the Series should be emailed to <[wps@sceme.org.uk](mailto:wps@sceme.org.uk)>. Following initial screening, we will ask one referee for feedback, which may prompt a round of revisions to ensure consistent standards across the Series.

## SUBMISSIONS

Please send your paper as a single file (must be MS Word, OpenOffice, or RTF): 1. Cover page; paper title, author names plus affiliation and email contact, abstract (<150w), up to six keywords, and up to four JEL codes. 2. Main text; should begin directly with the Introduction at the top of the page (no repetition of paper title), 'justified' paragraph layout, non-serif font (Arial, Helvetica) of 12pt size and 1.0 line spacing. All sections should be consecutively numbered, footnotes rather than endnotes should be used, and tables and figures should be included at the point where they are intended to appear in the main text. 3. References; should adhere to bibliographic conventions as applied in the *Journal of Economic Methodology*. All pages should leave a 3cm margin on all four sides.

Authors retain full copyright in their work. By submitting your paper, you grant SCEME a non-exclusive permanent license to make it accessible online. You also warrant that the paper does not infringe the rights of others and does not violate any applicable laws, and agree to keep SCEME and its affiliates indemnified in full against any loss and expense resulting from your breach of these warranties.

## PUBLICATION AGREEMENT

### SCEME WORKING PAPERS:

1. Connecting principles, new combinations and routines. *Brian J. Loasby, 2003.*
2. Uncertainty and monetary policy. *Sheila C. Dow, 2003.*
3. Algorithmic economics: A plea for natural economic history. *Matthias Klaes, 2003.*
4. Closed models and open systems. *Brian J. Loasby, 2003.*
5. The future for schools of thought in pluralist economics. *Sheila Dow, 2003.*
6. Evolutionary economics: In defence of vagueness. *Matthias Klaes, 2004.*
7. Variety of Opinion and the Speculative Demand for Money: An Analysis in Terms of Fuzzy Concepts. *Sheila Dow & Dipak Ghosh, 2004.*
8. Paradigms and 'epistemes' in the history of economic thought. *Iara Onate, 2004.*

SCEME WORKING PAPERS (cont.):

9. The paths of classical political economy and Walrasian economics through Bowles and Gintis' rendering of post Walrasian economics. *John H. Finch & Robert McMaster, 2005.*
10. Keynes and postmodernism. *Matthias Klaes, 2005.*
11. Plurality in economics. *Sheila Dow, 2006.*
12. Rationality and its bounds: Re-framing social framing. *Matthias Klaes, 2006.*
13. Uncertainty and growth: The case of transition economies. *Andrej Susjan & Tsaja Redek, 2007.*
14. Market masculinities and electronic trading. *Matthias Klaes, Geoff Lightfoot & Simon Lille, 2007.*
15. e-Commerce as a sign: The diffusion of electronic commerce in the UK ceramic industry. *Thea Hinde, 2007.*
16. Hayek's challenge to economists. *Brian Loasby, 2007.*
17. Individual deliberation, moral autonomy and emotions: Rousseau on citizenship. *Christophe Salvat, 2007.*
18. The ethics of efficiency. *Irene van Staveren, 2007.*

## The Ethics of Efficiency

Irene van Staveren

economics, as it has emerged, can be made more productive by paying greater and more explicit attention to the ethical considerations that shape human behavior and judgment.

(Amartya Sen, *On Ethics and Economics*, 1987: 9)

### Introduction

Efficiency is generally regarded as a value-neutral concept, concerned with assessing whether an economy produces at its possibility frontier, that is, generating maximum possible market output with given resources. Efficiency analysis generally rejects concerns with distribution – often referred to as equity – which leads to the common understanding of efficiency and equity as being trade-offs. This is also the comprehension of the widely applied Pareto efficiency criterion. The efficiency/equity trade-off reflects the strong influence of positivism on economics, whereby efficiency is regarded as located on the ‘positive’ side of economic science, and equity – as expressed by social welfare functions, rights, equality of liberty, or other distributive concepts – on the ‘normative’ side (Putnam and Walsh, 2007)<sup>1</sup>.

There is a solid body of critique of the concept of Pareto efficiency, and much of it is concerned precisely with its exclusive focus on efficiency, which allows for equilibrium situations that are dramatically unequal (Sen, 1987; Lutz, 1999; Schultz, 2001). Taking this criticism further, various authors maintain that equity is an important objective of its own, and should therefore be included in economic evaluation. According to the defenders of ‘normative

economics', equity concerns should not be left to politicians to be decided on, but should become part and parcel of economic analysis, which would allow economists to address more directly the pressing problems of underdevelopment, poverty, and environmental degradation (see, for example, Stillwell, 1975 and Mishan, 1981). Support for normative economics can be found across schools of thought, and has been around at least for the past forty years (see, for example, Bergson, 1966; Stilwell, 1975; Mishan, 1981; Bailey, 1992; Kolm, 1994 and 2000; Berg, 2003; Mongin, 2006).

However sympathetic I am to this position, sharing the deep concerns about inequality and deprivation, I will argue here that the project of 'normative economics' is missing the point and not very helpful in challenging the inconsistencies in the Paretian efficiency concept or for developing alternative efficiency criteria. By complementing equity evaluations to efficiency evaluations, the critics, just like the proponents of Pareto efficiency, tend to accept the presumed trade-off between efficiency and equity (see, for example, a plea for "methodological complementarity" by John Elliott, 2005: 462)<sup>2</sup>. The problem is that the defense of normative economics, as complementary to positive economics, reduces ethics to the Humean 'ought' category of morality, as expressed for example by Mishan (1981: 3), who simply states that "normative economics ... implies 'ought' propositions". Normative economics, hence, limits ethical concerns in economics to prescriptions for economic behavior and policy, that is, to value judgments stating what *should* be the case, as contrasted with what *is* the case<sup>3</sup>. It thereby ignores a wide variety of other ways in which economic evaluation is imbued with values, implying, perhaps unconsciously, that what does not fall into the 'should category' is by definition part of the 'is category'.

In this paper, I will challenge the dichotomy between positive and normative economics, focusing on efficiency, and hence, I will challenge the idea of a necessary trade-off between efficiency and equity. I will argue, instead, that efficiency is not a 'positive' concept – as dealing with facts only – but intertwined with values. In other words, this paper argues that "efficiency is

a value-laden term" (Blaug, 2001: 47). The values are a combination of epistemological values (elegance, equilibrium), methodological values deriving from particular ethical traditions (utilitarianism, libertarianism), value judgments in categorizations (what is included in the evaluation and what not) and in measurement (desire satisfaction, income, resources). I hope to make clear that efficiency is an ethical concept not because it *excludes* equity – as suggested by the positive/normative split – but because it *includes* value positions. Pareto efficiency, as a particular version of efficiency, is not immune to this, even though it was developed during the 1930s, the period of strong positivist influence on economics (Blaug, 2001).

The objective of the paper is twofold. First, it will argue that the moral stances underlying Pareto efficiency appear to limit its capacity to adequately evaluate efficiency, in its common meaning as the realization of more/most outcomes with less/least resources. Second, it will sketch the contours of an alternative efficiency concept, relying on heterodox economic traditions, which intends to address efficiency more adequately. The alternative concept will not be value-neutral either, but implies a weaker moral stance than the Paretian concept, recognizing the interrelatedness of equity and efficiency.

### **The Ethics of Pareto Efficiency**

The evaluative criterion of Pareto efficiency is generally formulated as the situation in which no one can be made better off without making at least one person worse off. The Arrow-Debreu proof of its existence relies on perfectly competitive markets, which by no means implies that Pareto efficiency cannot also be brought about otherwise, by regulated markets or markets influenced by a particular set of evolved institutions, or perhaps through the state or the gift economy. Moreover, the Pareto efficiency concept implies that for each possible initial distribution of endowments, competitive markets may bring about a Pareto efficient outcome, so

that multiple equilibria become a problem in selecting the most efficient economic outcome. The criterion relies heavily on voluntary exchange between agents, implying that if agents have exchanged, each of them must have made a gain, otherwise they would not have agreed to the transaction. Any interference with this process is regarded as a violation of people's voluntary action, and hence, as a disincentive for agents to freely produce and exchange. In turn, such a disincentive is seen to result in a lower level of efficiency, that is, it would make at least one person worse off.

The criterion of Pareto efficiency – and its parallel notion of Pareto improvement – is so commonly used in economic analysis, that it may be safely interpreted as a reasoned convention<sup>4</sup>. Conventions can be very useful in scientific discourse, as they facilitate mutual understanding and reduce the amount of time and effort spent on lengthy explanations of widely shared beliefs, rules of thumb, or strategies. However, as institutional economists following Thorstein Veblen have explained long ago, conventions can also have a dark side, expressing norms that can dominate, exclude, and remain in place when outdated. The critiques of Pareto efficiency, which have been expressed for decades, suggest that it is, indeed, not a harmless convention<sup>5</sup>.

Below, I will summarize the critiques that relate to the ethical foundations underlying Pareto efficiency: utilitarianism and libertarianism.

### Utilitarianism

One of the most influential ethical theories since the early nineteenth century is utilitarianism, summarized in Jeremy Bentham's famous 'greatest happiness for the greatest number'. Pareto efficiency relies heavily on this ethic: it is consequentialist, looking at total utility outcomes; and it evaluates efficiency in terms of desire fulfillment, making use of utility functions and a possibility frontier marking all allocations that maximize utility, or, in game theory, a limited set of numerical gains from which players can choose. Utility, thereby, is a complete and fully commensurable subjective measure of wellbeing, including desires that may be other-directed but

which primarily satisfy one's own utility, therefore sometimes referred to as 'self-interested benevolence' (Sen, 2002: 177n).

The choice of individual utility as the unit of measurement of Pareto efficiency, however, implies that it is not resource-use that is measured for the evaluation of efficiency. Rather, the assumption is that when total utility is maximized, this can only mean that resources must have been used to their maximum efficiency. This assumption, however, is incorrect. Modern economics has recognized that preferences may include psychological desires, relying on feelings of jealousy, status, affection, etc. So, it is not resource-use that is the space in which Pareto efficiency is measured, but desire fulfillment, including desires that are unrelated to resources (enjoying listening to birdsong or taking pleasure in humiliating one's employees) as well as desires that are highly resource-intensive (status symbols) or that are harmful for oneself but indulged in because of myopia, limited information, or weakness of will (also referred to as preference pollution, see George, 2001<sup>6</sup>). In addition, the satisfaction of some preferences generates externalities, affecting other agents' desire fulfillment. Hence, from a resource perspective, utility maximization does not necessarily result in the most efficient use of a society's resources: various preferences actually rely on or lead to a waste of resources. So, what is actually measured by Pareto efficiency is sub-optimal total utility, not minimum resource-use.

Paradoxically, a society with strong materialist values, in which status symbols, Veblen effects, weakness of will and negative externalities are rampant, is likely to achieve lower resource efficiency than a society with the same amount of resources but values that are more spiritual, long-term oriented, and responsible towards others and the environment (see, for a discussion of this paradox in the work of nineteenth century economist and novelist Charlotte Gilman: van Staveren, 2003).

What makes the disconnection between utility maximization and resource-use worse, is that Pareto efficiency has departed from utilitarianism in an important way, already in 1932, following Lionel Robbins' adherence to logical positivism. From then on, interpersonal utility

comparisons were no longer allowed in welfare analysis, following a strong version of the liberal no-harm principle. This strong no-harm principle makes a central part of Pareto efficiency and functions as an exogenous moral constraint prohibiting any redistribution that makes at least someone worse off, even when there would be a large net gain for society as a whole. The strong no-harm principle ignores real world agents' widespread willingness to redistribute resources towards weaker groups in society – a fallacy that has been recognized by Kenneth Boulding (1981) in economics, and Ronald Dworkin (1985) in ethics, and finds broad support from game theoretic experiments, such as the dictator game. As a consequence, the rich evaluative criterion of the 'greatest happiness for the greatest number' has been reduced to comparing states of affairs according to differences in levels of total utility, irrespective of marginal utility gains from redistribution. Without the strong no-harm principle, some inter-personal redistribution of resources could be justified as utility maximizing, up to the point that everyone's marginal utility would become the same, and total utility would be maximized, as Pigou (1929) had recognized already a century ago. The waste of resources for the sake of satisfying psychological preferences, for example by owning land for status reasons rather than to grow crops, would then likely be reduced through land redistribution to landless farmers, whose marginal utility from the actual use of land would likely be higher than the marginal utility enjoyed by the big landowner of the mere status-effect of owning additional land while not using it. Yet, the measure of Pareto efficiency is utility, not resource-use. Even interpersonal utility comparison and subsequent redistribution allows for the waste of resources because equalization of marginal utilities does not entirely eliminate the problems of desires that are unrelated to resources, create negative externalities, depend on waste, or are harmful to oneself or others.

In conclusion, Pareto efficiency does not guarantee efficient resource-use, because, first, it is measured as subjective desire fulfillment in utility space, and second, it relies on a strong moral constraint of no-harm of individual utility.

### Libertarianism<sup>7</sup>

In welfare economics, Pareto efficiency is applied to general and partial equilibrium analysis, assuming perfectly competitive markets, with some well known and highly unrealistic assumptions (no externalities, no barriers to entry or exit, and no economies of scale)<sup>8</sup>. This libertarian free market ideal holds that individual freedom is the highest good and should not be constrained by any state intervention. In other words, also the ethics of libertarianism relies on a strong version of the no-harm principle: no interference with voluntary exchange. Efficiency, then, is assumed to follow from this free exchange. The assumption, referred to earlier, is that perfectly competitive markets force every producer to minimize resource input. But this only holds for homogeneous markets, that is, in partial equilibrium analysis, *per market*. It allows, as we have seen above, inefficiency in consumption if consumers have preferences for product categories that are relatively wasteful of resources compared to other product categories, such as flying to a far-away holiday destination rather than a bicycle tour in one's own country<sup>9</sup>.

However, even when applied to the disaggregate level of individual markets, or in abstract game theoretic simulations, free markets will not necessarily result in efficient resource-use. This is, apart from the unrealistic assumptions, because free markets do not necessarily involve voluntary exchange. Hence, market allocations do not necessarily reflect what people want, under the constraints of budgets and prices. In libertarianism, the status quo distribution of resources is regarded to be just, as long as it is brought about voluntarily, through free exchange (and not by theft or state intervention, for example). However, the strong no-harm principle ignores the possibility that some agents lack the endowments for any beneficial exchange. In other words, libertarianism assumes that exchange is by definition voluntary when not forced or constrained from outside, while, as Walsh (2003) and others have argued, voluntary exchange can only exist when there is a feasible non-exchange option. Without such a fall-back, exchange of one's last resource or even non-economic goods, such as one's children or bodily integrity, will not be voluntary, but simply the only option for short-term survival. So, paradoxically, voluntary

exchange will only be voluntary with a feasible option for autarky, which can be – voluntarily – chosen in cases when the available exchange option(s) will not result in at least some gain over a reasonable period of time for both parties to the exchange. Distress sales may be regarded by libertarians as voluntary in a static sense, but they undermine an agent's resources base, and hence, crowd out productive capacity in the long run, which is clearly not efficient in a dynamic sense, making people dependent on others or the state. Distress sales can only be prevented by trade-independent security, deriving from resources such as savings, wealth, welfare support, or access to commons. In the real world, most people who experience a disadvantaged exchange position have very few resources to live off, except their labor power. And even this may not be in demand, as it may be only potential rather than actual labour power, due to lack of nutrition and health (Dasgupta, 1993), or it may not earn sufficient market value to survive (Kurien, 1996), or a combination of factors including lack of aggregate demand (Walsh, 1996). Hence, the strong no-harm principle of libertarianism benefits the status quo of the distribution of endowments, which, however, does not necessarily lead to the most efficient allocation of resources from a dynamic perspective.

The concept of Pareto efficiency seems to have an escape from situations with a highly unequal distribution of endowments in the Kaldor-Hicks compensation in which winners compensate losers and still receive a net gain. But, again, this is only likely to occur in a situation of not too high inequality, that is, in the absence of agents who have no trade-independent security. When losers have very limited resources – a meager fallback position in game theoretic terms – they are forced to accept any offer for short-term survival, while it is likely that no compensation offer will be made at all.

Libertarian free markets, hence, will not automatically result in efficient resource-use. First, because of the influence exerted by heterogeneous markets, power, increasing returns to scale, externalities, and asymmetric institutions. Second, because there is no guarantee of trade-independent security, which allows for involuntary exchange, and hence, for inefficient resource

allocations through the market power of those with relatively high endowments over those with relatively low endowments.

In conclusion, Pareto efficiency involves two ethical stances, the one deriving from utilitarianism and the other one from libertarianism. Both hold on to a strong version of the moral value of no-harm, regarding equity as reducing efficiency. But this strong no-harm principle actually prevents Pareto efficiency from reaching the most efficient resource allocation: it denies reallocations that would result in increased marginal utilities and it ignores crowding out of resources through involuntary exchange. Pareto efficiency, hence, appears to be not so much a criterion for evaluating efficient resource-use, but the application of a strong no-harm principle to idealized markets, measured in utility space.

## **Recent Adaptations of Pareto Efficiency**

In this section, I will briefly discuss two adaptations to Pareto efficiency, arising in two recently developed alternative approaches to welfare economics: happiness studies and the capability approach. The first remains close to the general equilibrium approach, but it allows for redistribution from winners to losers to increase total utility. The second approach adapts the Pareto criterion to a different space: not utility but opportunity freedom.

### Happiness Efficiency

In happiness studies, subjective measures of wellbeing are made comparable through the use of qualitative scales of wellbeing, measured in self-reports of life satisfaction (Frey and Stutzer, 2002)<sup>10</sup>. So, rather than relying on subjective, fully commensurable preferences as representing the ends which agents seek, in happiness studies it is substantive happiness that is recognized as

being important in itself<sup>11</sup>. Empirical studies of happiness suggest that subjective wellbeing depends positively on institutional factors, in particular democracy, next to economic variables such as income, while unemployment and inflation appear to lower happiness (Stutzer, 2001). Next to institutions, personality factors appear to matter too, as well as socio-demographic and situational aspects (Frey and Stutzer, 2002: 10-11). In a review of the literature on economic psychology, Diener and Seligman (2004: 25) summarize the major factors that appear to contribute to subjective wellbeing:

- live in a democratic and stable society that provides material resources to meet ends
- have supportive friends and family
- have rewarding and engaging work and an adequate income
- be reasonably healthy and have treatment available in case of mental problems
- have important goals related to one's values
- have a philosophy or religion that provides guidance, purpose, and meaning to one's life

The empirical happiness approach relies on comparable subjective valuations of wellbeing, in the kind of dimensions as listed above. These comparable valuations make it possible to re-introduce interpersonal utility comparisons in welfare economics, seventy five years after Lionel Robbins' ban. As a consequence, happiness studies allow for the identification of winners and losers in a particular state of affairs. This feature of happiness studies enables economic evaluations in terms of equity, comparing levels of self-reported wellbeing between individuals and groups. But it also allows for a better evaluation of efficiency, compared to the Paretian criterion. This is, because redistributions of resources from those with low marginal subjective wellbeing to those with high marginal subjective wellbeing will increase total happiness. Decision rules on such efficiency-improving redistributions are, however, not a simple matter, and can therefore not easily be addressed by cost-benefit analyses, despite optimistic views expressed by some (for example, Zerbe, 2001). Cost-benefit analysis, including measurement methods such as willingness to pay

surveys, is of limited use for the assessment of efficiency in the space of happiness, for three reasons: (1) income is a poor indicator of wellbeing across different classes, (2) some valued subjective goods can simply not be measured in monetary terms, and (3) compensation is not always possible, as is the case with tragic human or environmental losses<sup>12</sup>. It is more likely that decision rules for the redistribution of resources to maximize happiness will not be technical rules but rather “rules of social judgment”, as Sen (2002: 273) has termed them.

Compared to the application of the Pareto criterion in equilibrium analyses and some game theoretic experiments, in happiness studies income is not used as a proxy to measure of wellbeing. Instead, it only functions as one among other intermediary variables, and even for this task it is not a very good indicator because beyond a certain level of income, subjective wellbeing does no longer improve (Easterlin, 2001; 2002). Moreover, happiness studies have confirmed what Veblen already recognized a century ago, namely that relative income is likely to be more important for people’s mental states and life satisfaction than absolute income levels. Combining these insights on the limited satisfaction of income and the comparable, subjective valuation of a variety of non-income sources of wellbeing, an efficiency criterion for happiness could be formulated as follows. Happiness efficiency, then, is the situation in which the marginal rates of subjective wellbeing are equal for everyone. Happiness efficiency therefore, eliminates inefficiencies of low marginal utilities that are allowed by the Paretian criterion. It involves a far weaker form of the no harm principle than the libertarian one, and, interestingly, one that both increases equity (by reducing inequalities in happiness) *and* improves efficiency.

However, happiness efficiency keeps two other forms of Paretian waste in place. The first is waste resulting from perverse valuations. Such valuations are not unlikely because of the individualistic understanding of happiness: it is conceived of as an exclusively individual, not social state of mind. Hence, people can define their individual happiness in ways that go against social norms, shared values, or moral duty, for example. The valuation of something like status often requires inequality in wealth. For example, some big landowners may derive high

subjective wellbeing from the mere possession of land, not from its productive use. As a consequence, productive resources may go wasted. The second source of Paretian waste that is left untouched by happiness efficiency results from institutions that legitimate high rates of inequality. A society may be characterized by institutions, such as caste or gender, which make the disadvantaged believe that they are better off than they objectively are, leading to an adaptation of their subjective evaluations. As an example, Sen has referred to poor Indian women suffering from malnutrition, assessing their own situation as better than it objectively is compared to the situation of their better fed husbands, who, in turn, valued their own condition as worse than objective health indicators would suggest (Sen, 2002).

In conclusion, happiness efficiency replaces the Paretian strong no-harm principle with a weak no harm principle, thereby reducing the waste that results from low marginal subjective wellbeing.

### Opportunity Freedom Efficiency

In *On Economic Inequality*, Sen (1997) has suggested various alternative criteria to Pareto efficiency, all concerned with redistribution toward more income equality. In his most recent book, however, he departs more significantly from mainstream welfare economics by looking for an efficiency criterion in the space of opportunity freedom, in which wellbeing is understood in terms of capabilities. Efficiency in freedom space, instead of utility space, refers to an increased range and significance of the options available to individuals. In other words, choice becomes “maximizing over comprehensive outcomes” (Sen, 2002: 607). This view of freedom as opportunity leads Sen to formulate the criterion of ‘weak efficiency of opportunity-freedom’: “a state of affairs is weakly efficient in terms of opportunity-freedom if there is no alternative feasible state in which everyone’s opportunity-freedom is surely unworsened and at least one person’s opportunity-freedom is surely expanded” (Sen, 2002: 518).

In his capability approach, Sen consistently leaves the substance of opportunity freedom open to public debate about what a society values in terms of political, social and economic freedoms (Sen, 2002: 454). What he does make clear is that it is about freedoms to do or be, and not freedoms from, the negative freedom of libertarianism. It is therefore surprising to see that his efficiency criterion in opportunity freedom space copies the strong no harm principle of the Paretian efficiency criterion. His choice for an efficiency criterion that remains very close to the structure of Pareto efficiency is particularly unexpected because in various publications, he has criticized Pareto optimality precisely for its crude prohibition of redistribution (see, for example, Sen 1987 and 1997).

In an attempt to formalize Sen's alternative efficiency criterion, Qizilbash (2005) has linked it to the first fundamental welfare theorem with the additional criterion of 'no resentment'. This theorem, when applied to opportunity freedom, implies that the optimum of opportunity freedom can be attained in perfectly competitive markets when agents do not regret the choices, among feasible alternatives, that they have made. The question is, of course, what are feasible alternatives. Is feasibility limited to the initial distribution of endowments? Does it ensure trade-independent security? What about asymmetric processes of accumulation due to uncertainty, power, and human fallibility, which is likely to change the distribution of feasible alternatives between groups over time? In other words, it seems that on its own, even with an added criterion of no resentment, Sen's efficiency of opportunity freedom remains very close to the Paretian criterion, including its major flaw of the prohibition of interpersonal utility comparisons. This implies that it also allows for inefficiencies of low marginal opportunity freedoms.

On the other hand, the advantage of the efficiency of opportunity freedom is that the space in which it is measured is no longer the space of utility but of opportunity, a notion that requires public debate, and hence, will go beyond purely self-referential valuations as is the case in utilitarianism and happiness studies. Opportunities refer to the enhancement of real opportunities for oneself, the community to which one belongs, and society as a whole<sup>13</sup>.

Through its concern with real, and partly socially embedded opportunities, it is less likely that waste will occur through perverse preferences or false beliefs, as is the case in Paretian efficiency and happiness efficiency. Perverse preferences are not very likely to get priority in public debate (assuming, of course, that public debate will not be dominated by an elite). So, the strong no-harm principle is reduced by an objective, rather than subjective space of evaluation. Whereas false beliefs about one's relative or absolute freedoms are likely to become less important once a society enhances for everyone the capabilities that involve autonomous thought, planning one's life, reflection, and control over one's social and political environment (see for these capabilities, Martha Nussbaum, 2000).

In conclusion, the adaptations of Pareto efficiency as discussed in this section show two complementary redefinitions of efficiency. Happiness efficiency replaces the strong no-harm principle that does not allow redistribution from low to high marginal subjective wellbeing. It thereby reduces the waste of resources implied in agents' preferences. Efficiency of opportunity freedom changes the space in which efficiency is measured from utility to opportunity freedom. This is likely to reduce waste of purely subjective and self-referential preferences, by including social values and inter-personal capabilities among the opportunity freedoms that are to be maximized. The next section will draw upon the insights from these two adaptations, and will sketch the contours of an alternative efficiency criterion.

### **Efficiency as Minimization of Waste**

Efficiency in its most basic sense can be characterized as the minimization of waste, as Margaret Reid has argued long ago (Reid, 1934; 1943). She referred to waste in consumption when the rich consume far more than the poor; consumption of goods that have negative externalities (giving

the example of tobacco); inefficient methods of production (referring, for example to unpaid work in households); the allocation of resources in ways allowing for the under-use of means of production (referring to, for example, unemployment); and finally, she argued that some level of agricultural self-production protects rural families from unpredictable shifts in market prices, providing food security and preventing sales of assets in bad times.

Reid's understanding of efficiency as the minimization of waste has a rich tradition in the history of economic thought. It can be traced back to Adam Smith who recognized that the economy needs to provide sufficient employment as well as sufficient wages in order to allow everyone to live a life with dignity<sup>14</sup>. For example, Walsh (2000: 21) reminds us that Smith "is savage when he sees the surplus being squandered by the profusion of the great" and he also reminds us that Marx' concept of exploitation included the recognition of waste of the surplus when it is shifted from labor to capital. And the founder of institutional economics, Thorstein Veblen (1931: 126), has criticized the waste of conspicuous leisure and consumption, arguing that "the utility of both alike for the purposes of reputability lies in the element of waste that is common to both. In the one case it is a waste of time and effort, in the other it is a waste of goods." So, going back to the basics of efficiency as the minimization of waste, seems a relevant starting point for the development of resource-relative notions of efficiency. A note, however, is that waste is, of course, inherent in markets, since they thrive on creative destruction, as Schumpeter has pointed out. Minimization of waste is therefore always a relative notion.

A next step toward an efficiency notion that really is concerned with the waste of resources, is the recognition that real world economies are characterized by uncertainty, power and institutions. These imperfect conditions require a shift away from efficiency as a static criterion of evaluation – the evaluation of an equilibrium – to a dynamic criterion, evaluating waste in the economic *process*, rather than in an idealized market *outcome* as has been suggested by Mark Blaug (2001). We need to evaluate the economic process, as Smith, Pigou, Schumpeter, Veblen, and Robinson have recognized, because the economy evolves through the interaction

between agents, who not just compete over given scarce resources, but who influence scarcity, market access, control over resources, valued ends, and the institutions that serve their interests. It is these dynamics that need to be analyzed in markets in which “ruinous competition could become a ‘ruinous’ deflation”, in the words of Nina Shapiro (2005: 543), with institutions being adapted to the interests of powerful lobby groups and wages being reduced in the presence of unemployment<sup>15</sup>.

A resource-relative concept of efficiency, hence, is dynamic and understands markets as imperfect allocation mechanisms, next to a legitimate role of the state as well as the unpaid economy of households and communities. In addition, as we learned from the two adaptations of Pareto efficiency in the previous section, efficiency tends to be furthered by some extent of redistribution towards the resource-poor in economic processes that generate socially valued opportunities for all. This leads to an efficiency concept which includes, and even relies on, equity, in an endogenous way. Such relative equity in resources enables the crowding in of resources and their productivity. This is precisely the mechanism that implicitly underlies the literature on increasing returns and endogenous growth. Of course, not all forms of equity enhance efficiency – some social norms of equity go against efficiency as Philippe Platteau (2000) has shown. But where equity is concerned with enhancing access to resources, such as land and education (see on how gender equity in education reduces waste of human resources: Abu-Ghaida and Klasen, 2004), equity is likely to enhance efficiency.

An example of the positive feedbacks between equity and efficiency for the resource of land has become known as the inverse farm-size relationship. Literature on small holder agricultural production in developing countries reveals higher land productivity compared to large landowners. An explanation that has been empirically confirmed is “that food security stress placed on food-deficit farmers by staple price uncertainty elicits supra-normal labor activity” (Barrett, 1996). The underlying problem appears to be not so much market imperfections (although land tenure for the poor provides them of course with collateral for loans), but high

inequality in endowments, which, among others, results in low incentives to invest by those with weak tenancy rights. Moreover, as a World Bank paper has recognized recently, power of large landholders leads to a lock-in of highly unequal land distributions, which not only keep land productivity at sub-optimal levels, but also adds to the rural unemployment problem: “Large farmers are often well-organized and well-connected, and are able to lobby governments for special tax breaks, subsidies, and other special distortions. The consequence of these distortions is invariably that they face lower effective capital costs relative to labor costs, and therefore over-invest in more machines that replace labor than they would have had they not been able to obtain the tax breaks, subsidies and cheap credit” (van den Brink et. al, 2006: 21). Hence, in the case of land, it is the *inequality*, more than market failure, which prevents efficiency gains to materialize.

Equity is, of course, a value in itself, as the proponents of ‘normative economics’ rightly claim. Evaluation of economic processes on the basis of efficiency alone would be very limited and clearly incomplete. But to the extent that equity is related to efficiency – likely in a non-linear way (Cornea, 2004) – it may be regarded as the economic dimension of dignity, the Kantian expression of the inherent equality of human beings. Economic dignity, then, refers to the enabling of every agent to be productive, to control a minimum necessary level of resources, so that a minimum livelihood can be attained without being forced to distress sales or to life-long dependence on others or the state, undermining people’s autonomy and self-esteem.

In conclusion, a more realistic efficiency criterion, that is, one that indeed is concerned with minimization of the waste of resources, does not require a strong no-harm principle. To the contrary, it does not require any exogenous moral principle at all, but relies on an endogenous relationship between efficiency and equity, in which economic dignity crowds in production and productivity into the economic process.

## References

Abu-Ghaida, D. and S. Klasen (2004) 'The costs of missing the Millennium Development Goal on Gender Equity', *World Development* 32 (7), pp. 1075-1107.

Altman, Morris (2004) 'The Nobel Prize in Behavioral and Experimental Economics: A Contextual and Critical Appraisal of the Contributions of Daniel Kahneman and Vernon Smith', *Review of Political Economy* 16 (1), pp. 3-41.

Bailey, Martin (1992) *Studies in Positive and Normative Economics*. Aldershot: Edward Elgar.

Berg, Nathan (2003) 'Normative Behavioral Economics', *Journal of Socio-Economics* 32, pp. 411-427.

Bergson, Abram (1966) *Essays in Normative Economics*. Cambridge (MA): Harvard University Press.

Blaug, Mark (2001) 'Is Competition Such a Good Thing? Static Efficiency versus Dynamic Efficiency', *Review of Industrial Organization* 19, pp. 37-48.

Boulding, Kenneth (1981) *A Preface to Grants Economics. The Economy of Love and Fear*. New York: Praeger.

Bowles, Samuel, Herbert Gintis and Bo Gustafsson (1993) *Markets and Democracy: Participation, Accountability and Efficiency*. Cambridge: Cambridge University Press.

Cornea, Giovanni Andrea (ed.) (2004) *Inequality, Growth and poverty in an Era of Liberalization and Globalization*. Oxford: Oxford University Press.

Dasgupta, Partha (1993) *An Inquiry into Well-Being and Destitution*. Oxford: Clarendon Press.

Diener, Ed, and Martin Seligman (2004) 'Beyond Money. Toward and Economy of Well-Being', *Psychological Science in the Public Interest* 5 (1), pp. 1-31.

Dworking, Ronald (1985) 'Why Efficiency?', in *A Matter of Principle*. Cambridge (MA): Harvard University Press, pp. 267-289.

Easterlin, Richard (2001) 'Income and Happiness: Towards a Unified Theory', *Economic Journal* 111 (473), pp. 465-484.

- (ed.) (2002) *Happiness in Economics*. Cheltenham: Edward Elgar.

Frey, Bruno, and Alois Stutzer (eds.) (2002) *Happiness and Economics. How the Economy and Institutions Affect Well-Being*. Princeton: Princeton University Press.

George, David (2001) *Preference Pollution. How Markets Create the Desires we Dislike*. Ann Arbor: University of Michigan Press.

Kolm, Serge-Christophe (1994) 'Rational Normative Economics vs 'Social Welfare' and 'Social Choice', *European Economic Review* 38, pp. 721-730.

-- (2000) 'A Historical Introduction to Normative Economics', *Social Choice and Welfare* 17, pp. 707-738.

Kurien, C.T. (1996) *Rethinking Economics. Reflections Based on a Study of the Indian Economy*. New Delhi: Sage.

Lee, Frederic, and Steve Keen (2004) 'The Incoherent Emperor: A Heterodox Critique of Neoclassical Microeconomic Theory', *Review of Social Economy* 62 (2), pp. 169-199.

Lutz, Mark (1999) *Economics for the Common Good. Two Centuries of Social Economic Thought in the Humanistic Tradition*. London: Routledge.

Mishan, E.J (1981) *Introduction to Normative Economics*. Oxford: Oxford University Press.

Mongin, Philippe (2006) 'A Concept of Progress of Normative Economics', *Economics and Philosophy* 22, pp. 19-54.

Nussbaum, Martha (2000) *Women and Human Development. The capabilities Approach*. Cambridge: Cambridge University Press.

Pigou, Arthur (1929) *The Economics of Welfare*. Third Edition, London: Macmillan.

Platteau, Jean-Philippe (2000) *Institutions, Social Norms, and Economic Development*. Amsterdam: Harwood Academic Publishers.

Putnam, Hilary, and Vivian Walsh (2007) 'Facts, Theories, Values and Destitution in the Works of Sir Partha Dasgupta', *Review of Political Economy* 19 (2), pp. 181-202.

Qizilbash, Mozzafar (2005) 'Incommensurability and the First Fundamental Welfare Theorem', *Oxford Economic Papers* 57, pp. 664-673.

Quine, W.V.O. (1950) 'Two Dogmas of Empiricism', in *From a Logical Point of View*. Cambridge: Harvard University Press.

Reid, Margaret (1934) *Economics of Household Production*. New York/London: Wiley/Chapman & Hall.

- (1943) *Food for People*. New York/London: Wiley/Chapman & Hall.

Roth, John (ed.) (1995) *The International Encyclopedia of Ethics*. London: Fitzroy Dearborn. London: Macmillan.

Schultz, Walter (2001) *The Moral Conditions of Economic Efficiency*. Cambridge: Cambridge University Press.

Sen, Amartya (1987) *On Ethics and Economics*. Oxford: Basil Blackwell.

- (1997) [1973] *On Economic Inequality*. Oxford: Clarendon Press. Expanded Edition.

- (2002) *Rationality and Freedom*. Cambridge: Belknap Press of Harvard University Press.

Shapiro, Nina (2005) 'Competition and Aggregate Demand', *Journal of Post Keynesian Economics* 27 (3), 541-49.

Staveren, Irene van (2003) 'Feminist Fiction and Feminist Economics. Charlotte Perkins Gilman on Efficiency', in Drucilla Barker and Edith Kuiper (eds.) *Toward a Feminist Philosophy of Economics*. London: Routledge, pp. 56-69.

Stilwell, F.J.B. (1975) *Normative Economics: an Introduction to Microeconomic Theory and Radical Critiques*. Oxford: Pergamon.

Stutzer, Alois (2001) 'What are the Sources of Happiness?', in Bruno Frey (ed.) *Inspiring Economics. Human Motivation in Political Economy*. Cheltenham: Edward Elgar, pp. 135-146.

Veblen, Thorstein (1931) [1899] *The Theory of the Leisure Class*. New York; Dover Publications.

Walsh, Vivian (1996) *Rationality, Allocation, and Reproduction*. Oxford: Clarendon Press.

- (2000) 'Smith after Sen', *Review of Political Economy* 12 (1), pp. 5-25.

- (2003) 'Sen after Putnam', *Review of Political Economy* 15 (3), pp. 315-394.

Zerbe, Richard (2001) *Economic Efficiency in Law and Economics*. Cheltenham: Edward Elgar.

## Notes

---

<sup>1</sup> Some authors, however, put all of welfare analysis – including exclusive concerns with efficiency – on the normative side, whereby welfare economics becomes a synonym for normative economics (e.g. Mishan, 1981).

<sup>2</sup> In their most recent article on the dichotomy between positive and normative economics, Putnam and Walsh try an explanation for this widespread resistance to the idea that facts and values are entangled: “Part of the problem may be that, in present day society, people still retain a view of science that made sense only when supported by the arguments of logical positivism: we still *expect* scientific statements to be value free (Putnam and Walsh, 2007: 188).”<sup>2</sup> Further on, after reviewing the attack on logical positivism by Quine (1950), they ask us “when entanglement is an essential trait of the hard sciences, why should a social science like economics expect to stand aloof from it?”(ibid: 190), ending with the rhetorical question: “why should it even *want* to try?”

<sup>3</sup> Even though economic dictionaries and textbooks are quite clear about what normative economics is, it should be noted that, to quote Philippe Mongin (2006: 19) “it is notoriously hard to say what exactly normative economics is about”. But in general, the focus is on judgment of “the relative desirability of economic states of affairs” (ibid p. 20), or, in the words of Kolm (2000: 707), “ethical judgments about the economy and notably about the distribution of goods and the rights and rules that lead to it”, or, in short “finding out what should be done” (Kolm, 1994: 721).

<sup>4</sup> I take the term “reasoned convention” from Sen (2005: 110), where he introduces it in order to show how strong the role of conventions is in economic discourse. It particularly holds for values such as efficiency, freedom to choose, or equilibrium, to name just a few examples of such reasoned – and value-laden – conventions.

<sup>5</sup> Pareto efficiency can rightly be interpreted as a reasoned convention, since it appears regularly in economic texts and in economic teaching. For example, it is present in 53% of 74 economic textbooks that have been reviewed by Fred Lee and Steve Keen (2004) for what they regard as problematic core economic concepts.

---

<sup>6</sup> See for an insightful study, David George (2001) *Preference Pollution. How Markets Create the Desires We Dislike*. Ann Arbor: University of Michigan Press.

<sup>7</sup> The International Encyclopedia of Ethics (Roth, 1995) recognizes that libertarianism is part of liberalism, and is also referred to as classical liberalism (deriving from John Locke). But while libertarianism holds that the defense of liberty requires a minimal state, regarding individual autonomy as the fundamental social principle, liberalism is, according to Roth, a progressive attitude toward social change, implying a generosity of spirit, liberality of sentiment and attitude of tolerance that value individual differences and human dignity.

<sup>8</sup> The tautological solution to externalities is simply to create additional markets, through establishing property rights to an externality – ad infinitum, which is rather unfeasible, as Walsh (1996) has rightly noted.

<sup>9</sup> Competition between airlines may drive resource-use in that market to a minimum, but per consumer-holiday it is still well above that of the market for bicycle holidays: these two product categories, and hence distinct markets, are simply not very good substitutes.

<sup>10</sup> This should be distinguished from objective measures of happiness, as pursued in cardinal measures of utility, for example using the measurement of brain waves.

<sup>11</sup> Frey and Stutzer (2002) rightly refer to Aristotle's view that a happy person is a moral person, to Aquinas' idea that the quality of life includes closeness to God, and Adam Smith's insight on the limits of income and material goods to create utility.

<sup>12</sup> How would one answer a question such as "how much are you willing to give up in order to change your religion?", or "how much are you prepared to pay in order to acquire a belief in the fairness of equal treatment of women in the labour market?"

<sup>13</sup> There is still the risk, as in the happiness approach, that some people's freedom depends on perverse use of resources, as Sen leaves open what people have reason to value. It is thus possible that scarce resources are used for wasteful activities that people believe increase their opportunities.

<sup>14</sup> Adam Smith, in the *Wealth of Nations*, recognized two objectives for the economy: "first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient

---

for the public services" (Adam Smith, (1981) [1776] Book IV. Introduction: 428). Moreover, he plead for sufficient wages: "... in order to bring up a family, the labour of the husband and wife together must, even in the lowest species of common labour, be able to earn something more than what is precisely necessary for their own maintenance"(ibid, Book I. VIII: 85-6).

<sup>15</sup> In the case of excess supply of labour wages may fall below subsistence level: this is likely to lead to very low levels of labour productivity (Altman, 2004). Alternatively, labour productivity tends to be influenced by the extent of decision making power of workers in a firm, leading to a 'wage incentive effect' (Bowles and Gintis, 1993: 29).