Efficiency, Equity, and Paternalism

Why do people advocate different public policies? Some people passionately oppose policies that are avidly endorsed by others. At the beginning of this course, we reviewed the terms "positive economics" (what is; matters of fact) and "normative economics" (what should be; matters of opinion)—and we said that we would focus largely on "positive" analysis. To this point in the course, we've done that—in trying to refine our ability to identify all of the relevant costs and benefits of personal decisions and public policies. But now as we turn to discuss the role of government within the economy, we need to discuss normative factors in trying to understand what people want and expect from government policy.

The other thing we'd like to resolve at this point in the course is why politicians pass what seem to be poor policies. If monopolies are not good for society, why are politicians so active in enhancing monopoly power? If markets are typically so effective, why are governments so fond of using price regulations, taxes, and subsidies to subvert the market? At this point, we've talked mostly about efficiency as a criterion to judge public policy—and found many policies that are inefficient. Apparently, we need to study the motives and behaviors of agents in political markets—politicians, bureaucrats, and voters—in order to gain a better understanding of why government is allowed to interfere with markets in any given context. It turns out that people use criteria other than efficiency to make decisions about public policy—what we will call "equity" and "paternalism". Before we turn to those, let's review efficiency.

Efficiency

Efficiency is an old friend of ours at this point in the course. Outcomes are efficient under the five assumptions of our basic model—when
1.) rational agents are
2.) engaging in voluntary trade with
3.) reasonable levels of information in
4.) a relatively competitive market that is
5.) largely unregulated by government.
In such circumstances, trade will be mutually beneficial and resources will be allocated by the market to their highest-valued uses—in a socially efficient manner.

Moving away from any one of these assumptions will result in inefficiencies—what we've called "deadweight losses". If agents in the marketplace are not "rational", if trade is coerced or fraudulent, or if one participant has significant market power over the other, then "voluntary" mutually beneficial trade is not assured. Further, if an otherwise-efficient market is regulated by the government, then economic activity will be artificially decreased or increased away from the

socially efficient level. Government policy, then, can introduce inefficiencies by regulating an otherwise efficient market. But in cases where markets are inefficient, it is possible—at least in theory—for government to intervene in a way that enhances efficiency. Coming into today's discussion, we've talked about three of the five cases.

Five Areas Where Government Intervention Can Improve Efficiency

First, recall the debate in macroeconomics between the non-activists and the activists. During a recession, resources are unemployed and thus, are being allocated inefficiently. Proponents of activism believe that the market's "self-correcting mechanism" is too slow when trying to recover from a recession—and that government activism is relatively effective in fixing the problem.[1] So, at least in theory, government activism can regulate *the business cycle* and reduce inefficiency.

Second, we talked about the problems associated with *significant market power* (e.g., when a firm has monopoly power over consumers). In such cases, one party has a significant advantage in bargaining power over another party, resulting in inefficiencies (e.g., the monopolist artificially reduces quantity in order to charge prices above the competitive level). In this context, at least in theory, government can regulate prices effectively in order to simulate competition and can enforce anti-trust laws to keep competition at a sufficient level.

Third, we talked about *"imperfect information"*—when a lack of information is significant enough to affect market transactions. This is especially true when the information is asymmetric between buyers and sellers, giving one party a clear advantage over the other. In such cases, the market often finds innovative ways of dealing with the information problem—at least in part. Beyond that, in theory, the government can play a role in reducing search and transaction costs—and by legally protecting the party with relatively little information. (In today's class, we will add the two other categories to finish the list: "public goods" and externalities.)

Government policy also contributes to—or takes away from—social efficiency through its choice of *"institutions"*. In other words, the government establishes or influences "the rules of the game" through its policy choices. As we've discussed off-and-on throughout the semester, government can promote efficiency or inefficiency to the extent that it protects property rights, enforces contracts through

---

[1] The primary stories about the market's inability to adjust are based on "imperfect information"—assumption # 3 above—that workers are "confused" about the difference between nominal and real wages and that firms are tied into long-term contracts when underlying market conditions have changed.

an effective judicial system, maintains a stable monetary system and a currency with integrity, assesses low marginal tax rates, allows domestic and foreign trade and investment, and so on.

What Else Determines Policy Outcomes Aside from Efficiency?

All of the above still leaves us with the question of why agents in political markets would choose to introduce inefficiencies into an otherwise efficient market. As long as the costs are recognized (at least in part), there must be some benefits that make the costs worthwhile in the eyes of voters and policy-makers. Those benefits can be classified in the categories of equity and paternalism.

Paternalism

Paternalism takes us back to the first assumption of our model—that market participants are assumed to be "rational". To review this concept: to an economist, this means that people are able to weigh available benefits and costs effectively and make decisions that will "maximize utility" subject to their budget constraint (their income and market prices). As we noted early in the course, this is an important assumption because when we assume people are "irrational", then there's no way to assess, understand, or predict what they will do.

For example, in seeing someone order anchovies on a pizza, we can say that they're irrational and stop our analysis—or we can attribute the choice to "tastes and preferences" or other factors (e.g., a sale on anchovies or a law mandating their inclusion on pizzas) and continue to analyze the decision-making process. If the person is truly irrational, then we cannot say that they would respond to a change in economic, social, or legal costs. Or if eating anchovies on pizza is a sign of irrationality, then we could not explain why people would ever begin to eat anchovies—even if they were free or were determined to prevent cancer. Thus, as a precursor to analysis, we start with the assumption of rationality and do our best to explain and predict behavior.

All that said, people often implicitly assume that other people are not rational.[2] Beyond that, in the realm of public policy, some people advocate government activism to prevent people from making "the wrong decisions" or to force them to make "the right decisions". Government can mandate or subsidize good decisions and can prohibit or tax bad decisions. In this sense, government can act as a "father"—or more broadly, as a parent—to paternalistically "encourage" us to make the right choices. Can you think of some examples where paternalism is a key criterion in advocating a public policy?

---

[2] On rare occasion, they might think the same thing of themselves. This gets into the study of "self-control mechanisms" where one voluntarily imposes an "unnecessary" cost on oneself in order to reach a desired end.

In fact, there are a number of examples. The government allows young people to do certain things only at certain ages (e.g., to drive, work, drink alcohol, or vote). The government gives poor people "food stamps" because we don't trust that at least some of the recipients will spend the resources appropriately. The government tells us to buckle our seat belts and to wear motorcycle helmets for our own good. The government can use prohibition or taxation to discourage us from ingesting certain things (e.g., illegal drugs, cigarettes, fast food). And the government forces us to "contribute" monies to support current retirees while promising us a future retirement income derived from a very poor rate-of-return (if we live that long)—all because some of us are not trusted to save for our own retirements.

Do people always make the right decisions, even with adequate information? Of course not. But should government force be used to encourage people to make the right decisions? And will the use of government force make them more or less capable to make good decisions in the future? Will government force be used on me someday to regulate my "bad" decisions? The answers to these questions are debatable and subjective—and thus, a matter of "tastes and preferences" within the realm of "normative economics". But views on these questions clearly affect the public debate on optimal policy. Even with the same assessment of an individual's ability to make decisions, people differ considerably on whether government policy should be invoked in these contexts.

Equity

The final criterion is equity. The term has two basic meanings, both of which have some connection to economics. One common usage is equity as the value of an asset. For example, if you owe $100,000 on a house worth $150,000, you have $50,000 of equity in that house. Here, we mean equity to be a sense of "fairness" applied to process, outcomes, or both. For example, you might find the current distribution of income or wealth in the United States (an outcome) to be fair or unfair. Or you might find the redistribution of income from taxpayers and consumers to wealthy farmers (a process) to be fair or unfair. As the examples indicate, "fairness" is in the eyes of the beholder—again a subjective and normative matter, but also a crucial factor in determining policy outcomes.

For processes and outcomes that are viewed as equitable and efficient, there will be little substantive debate. But for policies that are efficient, but considered inequitable, the debate becomes more interesting. Some people are willing to sacrifice considerable efficiency to reach solutions they consider to be equitable;

other people will not be willing to make that trade-off.[3] Thus, well-informed people of good will can come to different policy conclusions on the basis of their tastes and preferences with respect to equity. (Of course, many people don't know much about the efficiencies or inefficiencies and base their positions, by default, largely on equity issues.)

For example, it is inefficient to significantly increase the national minimum wage.[4] If the wage floor is lifted above market equilibrium wages, the bad news is that the quantity supplied of labor by workers will increase, while the quantity demanded of unskilled labor by firms will fall—resulting in a surplus of labor (i.e., unemployment).[5] The good news is that wages for the unskilled laborers who keep their jobs will rise. Overall, there are clearly inefficiencies—as resources are forcibly moved to alternative (second-best) uses, and most notably, as some resources go unemployed.

Some people don't understand the costs of the policy and its social inefficiencies—and thus, advocate the policy on the basis of its benefits alone. Others oppose the process itself as unfair. (Why should the government prevent people from engaging in mutually beneficial trade in this context?) Some people are unenthused about personally bearing the costs of the policy. Others don't mind the personal costs, but recognize the social costs of the policy and oppose it. Still others recognize all of the costs and inefficiencies but believe that imposing costs on owners, consumers, and other unskilled workers is an ethical means to desirable ends.[6]

As should be clear from the example, support for or opposition to a policy can be based on different knowledge of the costs and benefits of the policy, different views about equity in weighing those costs and benefits, and different weights on the importance of equity and efficiency. At the end of the day, the economist's primary job is to teach critical and creative thinking about the costs and benefits of personal decisions and public policies. But even if that task is completed, people will disagree on decisions and policies as a function of their tastes and preferences for efficiency, equity, and paternalism.

---

[3] I have devised some equity/efficiency experiments that are able to measure this to some extent.

[4] This assumes that, unlike today, the national minimum wage is elevated to a level that actually influences a significant number of market outcomes.

[5] There are additional factors that may mitigate any or all of these outcomes, but they go beyond the scope of this course.

[6] This example also ignores other, relatively-efficient policy outcomes—such as the Earned Income Tax Credit and wage subsidies—that reach the policy goals without imposing costs on unskilled workers and promoting unemployment.