Economic Efficiency Versus Egalitarian Rights

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'The domain of rights is full of infringements on the calculus of economic efficiency . . . Everyone but an economist knows without asking why money shouldn't buy some things. But an economist has to ask that question' [OKUN, 1975, pp. 10, 13].

Money buys bread, cars, books, hair-cuts, etc. but not (legally anyway) slaves, votes, exemptions from military services, political offices, etc. ¹. Some of these 'blocked exchanges' may be explained in terms of economic efficiency by such considerations as external costs/benefits. On the other hand, many rights for individuals may also be explained by the need to impose restrictions on the power of the state to ensure individual freedom and hence welfare. It is not the purpose of this paper to discuss such efficiency-consistent rights and restrictions, but those that infringe upon economic efficiency. Why limiting the domain of economic efficiency to some restricted sphere?

Secondly, it should be noted that the infringement of economic efficiency is different from the replacement of the market by political or collective action as such since the latter, at least in principle, may be decided in accordance with the pure efficiency principle of 'a dollar is a dollar' rather than 'one man one vote'. Similarly, the adherence to economic efficiency does not preclude the adoption of a wider perspective recognizing indirect and non-pecuniary costs and benefits (as argued, for example, by RHOADS [1985, Part III, especially Ch. 10]).

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¹ For a fairly long list of 'blocked exchanges', see WALZER [1983, pp. 100–103].
1. ECONOMICS VERSUS POLITICS

At least in the English-speaking world, two most influential definitions of economics are those made by MARSHALL and ROBBINS. MARSHALL [1920, p. 1] defined economics as ‘a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing’. ROBBINS [1935, p. 16] defined economics as ‘the science which studies human behaviour as a relationship between (given) ends and scarce means which have alternative uses’.

Each of the above definitions captures some important aspects of economics though each may be said to be too wide in certain aspects and too narrow in others. For example, MARSHALL’s definition may be said to subsume much of sociology, psychology, anthropology, and politics. On the other hand, in many non-ordinary pursuits of life, the question of economizing choice is certainly involved.

Despite the difficulty of a precise definition², most students of economics (if not most people in the streets) have a fairly clear but rough idea as to what problems belong to economics and what not. For example, everyone agrees that the problem of resource allocation in the production of commodities is an economic one while the choice of presidents or prime ministers is in the realm of politics. In between these two clearly classified realms, there is a more-or-less continuous spectrum with different degrees of mixture in the economic versus the political aspect of an issue.

At the economic end, most people accept the use of economic principles of resource allocation and distribution of private goods, including the use of the unweighted willingness (and ability) to pay as the measure of benefit³. At the political end, most people accept the use of ‘one person one vote’, and would not even consider, not to say accept, the use of willingness to pay in deciding political choice.

² It is well-known that some philosophers define philosophy as what philosophers do. One philosopher defined philosophy by pointing at all his books and said, ‘philosophy is what all these books are about’.

³ See the end of section ‘A Dollar is a Dollar: Generalization’ on the ambiguity of the measure.
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Again, in between the two, there are grey areas, e.g. health care, education.

Ignoring questions of ignorance, capital market imperfection, and other practical difficulties to be discussed below, if the rich prefer president X or procedure Y more (in terms of willingness to pay) than the dispreference of the poor and actually pay for having their way, it is unclear that a distinction between different spheres is clearly indicated. An economist is inclined to think that, unless there are some other overriding considerations, it is better to have half equality in both economic and political spheres, than to have full equality in one and none in the other. This paper is an attempt in search of such overriding considerations.

II. REASONS AGAINST ECONOMIC EFFICIENCY

A host of reasons account for people’s objection to the calculus of economic efficiency for decision-making in non-purely economic spheres. First, and probably foremost, there is the egalitarian objective trying not to give the rich too much influence while giving the poor more influence in order to make the poor better off. As is argued in the next section, this egalitarian objective can largely be met better (subject to practical difficulties and minor qualifications to be discussed below) through redistributive taxation rather than through the limitation of the sphere of application of the economic principle. Roughly speaking, an expansion of the application of the economic principle improves overall efficiency as well as making the rich better off (while possibly making the poor worse off). By making redistributive taxes/subsidies more progressive at the same time, every group will be made better off, achieving a quasi-Pareto improvement [Ng, 1984].

Secondly, due mainly to tradition and other cultural influences, people have preferences on the procedure or method of decision-making other than their instrumental value in bringing about desired outcomes (referred to as ‘procedural preference’ below). Thus, if people prefer one-person-one-vote, the use of this method directly yields utility. This is a fact which cannot be ignored. Even if the use of an alternative method is more efficient in terms of securing a better
outcome, it has to be better than the outcome under one-person-one-vote by a sufficiently big margin to offset the direct preference for one-person-one-vote for it to be desirable overall 4.

Why do people have procedural preference? It may be due to the belief than an equitable method, even if it produces less desirable outcome in the short run, is nevertheless preferable due to its contribution to social welfare in the long run. This is still within the framework of welfarism (social choice depends only on individual welfares) and the long-run effects can be analysed within the framework of social welfare maximization 5. On the other hand, the preference may be due to tradition, dogmatism, or other sources of ignorance and/or irrationality.

An example where procedural preferences may be involved is the gift relationship [Titmuss, 1971 and Singer, 1972]. For example, many people may be prepared to donate blood free but unwilling to sell at a price. Free blood donation signifies altruism while selling at a price signifies desperation. The fact that a price is paid for the blood, (1) makes the person financially better off, (2) deprives him of the sense of altruism, (3) imposes upon him a sense of degradation (to the level of having to sell blood to make ends meet). For most people, (2) and (3) are more important than (1). Moreover, paying for blood involves costs to the blood collector. It is thus almost certain that the abolition of the present free donation system would be undesirable. Nevertheless, where free donation results in too few supply to meet

4. One may argue that procedural preference does not really justify the infringement of economic efficiency; it just means that the costs/benefits related to procedural preference should be included in the calculation of economic efficiency. This is a semantic point and we shall follow the convention of not including the consideration of procedural preference under the calculation of economic efficiency.

5. For example, Kuttner [1984, p. 231] believes that universal and equal entitlement to basic education and health care is not only a decent social policy, but serves to reinforce a sense of community and solidarity. However, it is commonly ignored that, equality in these spheres implies greater inequality in other spheres if the same degree of incentives is to be maintained. Also, in writing that when 'the middle class shares basic public services with the poor, the middle class demands high quality and dignified treatment', Kuttner [1984, p. 231] may also have forgotten about the direct costs of providing such high-quality treatment universally, not to mention the indirect costs of administration, compliance, evasion, lobbying, and disincentive effects of the necessary extra taxation.
the demand, as may be the case with the AIDS scare, resort to some forms of paying for blood may be desirable. It is however essential to keep the present donation system and make it quite distinct from the payment system in order not to discourage donation.

Related to the gift relationship is the love relationship, including patriotism, the love for one's country (countrymen really). By (my) definition, A loves/hates B if an increase in B's happiness/unhappiness increases A's happiness. Deep love is defined to be the willingness to sacrifice one's own welfare for the welfare of the loved ones. Different degrees of love and of deep love may be measured by the corresponding coefficient or relation. If one expects sufficient compensating gain now or in the future, it would not really be sacrifice. Usually, both the lovers and the loved ones gain from love since loving and being loved make them feel good. This does not disqualify it from being defined as deep love since the willingness to sacrifice one's welfare is not conditional on the eventual gain from feeling good about loving. The meticulous use of the economic calculus of gains and losses may destroy the good feeling associated with love.

A variant of procedural preference is the importance placed on equality of opportunity in contrast to equality of outcome. People are less adverse to unequal distribution if everyone has equal opportunity to make his/her millions. This largely explains why people are adverse to the fact the children of the rich enjoy better education, contact, inheritance, etc. It seems that most people would rather have the rich themselves enjoy their riches but not pass on to their offsprings through better education and inheritance. While this may reduce inequality in future generations, inequality in consumption now is actually increased, not to mention the loss in efficiency. Nevertheless, people may still prefer this because of the equality of opportunity6.

III. A DOLLAR IS A DOLLAR: GENERALIZATION

In Ng [1984], I proved the following proposition: For any alternative (designated A) using a system (designated a) of purely equality-

6. Another variant of procedural preference, the perceived unfairness of price allocation, is discussed in a later section.
oriented preferential treatment between the rich and the poor, there exists another alternative, B, which does not use preferential treatment, that makes no one worse off, achieves the same degree of equality (of real income, or utility) and raises more government revenue, which could be used to make everyone better off.

Essentially, for any alternative A using a given preferential system a and a given income-tax schedule $\alpha$, there exists an alternative B without using any preferential system but with the income-tax schedule changed to $\beta$ in such a way that changes in the amounts of taxes/subsidies exactly compensate for the gains/losses of the dismantling of the preferential system a. This makes the representative individual at each income level still find it best to earn the same level of pre-tax income, producing neither changes in incentives nor in the distribution of real incomes (utilities). However, government revenue can be shown to increase under alternative B, due to the absence of any inefficient preferential system.

What I want to argue here is that, ignoring issues of practical difficulties, individual ignorance, irrationality, and procedural preferences discussed above, the proposition of treating a dollar as a dollar (pure economic efficiency calculation) can be generalized to cover all issues including non-economic ones. To see this, first note that the

7. The proof of the proposition is based on the assumption of a common utility function with different earning abilities (i.e. the Mirrlees model) and hence states a strict Pareto improvement. With different utility functions, we have to work on a representative individual at each income group, with alternative B making every income group better off (some individuals in each group may be slightly worse off), achieving a quasi-Pareto improvement. The proof also assumes a system of perfect preferential treatment where the degree of preferential treatment is monotonically decreasing in incomes. However, it was shown that 'the problem of imperfection in preferential treatment does not affect' [Ng, 1984, p. 1049] the conclusion. Nevertheless, if the benefits/costs involved is not only related to the income level but also to the ability level, some changes in incentives may result under alternative B. However, this effect is unlikely to be large. Even if the subjective benefits/costs are completely unrelated to income, the 'objective' benefits/costs in terms of the willingness to pay (which is the one relevant for the issue here) will still be largely related to income. More importantly, to the extent that benefits/costs can be designed to be related to the ability level, a tax/subsidy can also be designed; see section IV of Ng [1984] which also discusses complications such as political constraints in changing the progressivity of income taxation, transaction costs, etc. shown not to affect the main thrust of the argument.
proof of the proposition is exactly unaltered if the preferential treatment is not equality-oriented but inequality-oriented. Instead of counting a dollar to the poor as worth less than a dollar to the rich in cost-benefit analysis, it is better to tax the poor more and the rich less.

Next, note that the proposition applies to any alternative (not just preferential treatment) that is not based on the calculation of economic efficiency. For example, an alternative based on random treatment, one based on tradition, etc. can all be shown to be inferior to some alternative B defined to compensate for the gains and losses as outlined above.

It should be noted that my 1984 paper proves that a dollar should be treated as a dollar, but it does not prove that a billion dollars is a billion dollars. Due to diminishing marginal utility of income (or risk aversion with respect to income), a person (whether rich or poor) typically regards the gain of a billion dollars as less than a thousand times the gain of a million dollars. The use of either CV or EV (compensating or equivalent variation of income) may thus not proportionately measure the non-marginal gains and losses involved. For gains and losses that are thinly spread out, the inaccuracy involved is trivial. When it is not trivial, the use of marginal dollar equivalent (the number of times the gain is worth the gain of a marginal dollar) instead of CV or EV may be desirable [see Ng, 1983, Appendix 4A].

IV. RIGHTS VERSUS DOLLARS

The 'domain of rights is full of infringements on the calculus of economic efficiency. Our rights can be viewed as inefficient, because they preclude prices that would promote economizing, choices that would invoke comparative advantage, incentives that would augment socially productive effort, and trades that potentially would benefit buyer and seller alike' [Okun, 1975, p. 10]. However, far from arguing for the removal of 'inefficient' rights, Okun offers one of the most systematic justifications for economically inefficient rights.

8. Frey's [1986] more comprehensive treatment is discussed below. For another comprehensive discussion covering such issues as exploitation, alienation, etc. not
According to Okun, the justifications for rights take three routes: libertarian, pluralistic, and humanistic. 'To the advocate of laissez-faire, many rights protect the individual citizen against the encroachment of the state, and thus convey benefits that far outweigh any cost of economic inefficiency' [Okun, 1975, p. 101]. This is quite true but it only explains the existence of individual rights (against the state) but does not explain the infringement on economic efficiency. For example, why shouldn’t individuals be allowed to trade in rights?9

The second justification for rights is called pluralism. ‘... the network of relationships in a viable society had to rest on a broad base of human motives and human interests. Material gain is (at most) one of the many motives propelling economic activity’ [Okun, 1975, p. 121]. However, I fail to see how pluralism justifies rights that infringe on the calculus of economic efficiency, other than the question of procedural preference discussed above10. Of course, I perfectly agree that material gain is not everything, that fame, friendship, love, etc. are important. However, this only means that we should not ignore the values of these in our calculus of economic efficiency.

Pluralism means that individual welfare \( w^i \) is not just a function of economic variables \( x^i_1, x^i_2, ... x^i_n \) but also a function of non-economic variables \( z_1, ..., z_m \). Maximizing a Paretian social welfare function \( W(w^1, w^2, ..., w^s) \) subject to either \( F(X_1, X_2, ... X_n, z_1, ..., z_m) = 0 \) or \( F(X_1, X_2, ... X_n, \bar{z}_1, ..., \bar{z}_m) = 0 \), where \( s \) = number of individuals, \( X_i = \sum_{j=1}^{i} x^i_j \), we still have the familiar first-order conditions for an interior solution: \( F_j/F_k = w^i_j/w^i_k \) for all \( i \) and all \( j \) and \( k \), where \( F_j = \partial F/\partial X_j \), \( w^i_j = \partial w^i/\partial x^i_j \). Economic efficiency should still prevail even with pluralism, unless economic efficiency or the method to achieve efficiency itself is one of the \( z \)'s that enter negatively into the \( w \)'s. This is the issue of procedural preference discussed above.

...discussed here, see Buchanan [1985]. See also Dahl and Lindblom [1953, especially Chapter 14] which really justifies non-market choice rather than the infringement of efficiency.

9. I am not in favour of free trade in rights inconsistent with efficiency due to such factors as monopolistic power, externalities, etc.

10. In the section on pluralism, Okun also discussed 'diversification' (putting eggs in many baskets) which really relates to uncertainty (discussed in the text below) rather than pluralism.
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'A third explanation for rights stresses their recognition of the human dignity of all citizens. JOHN RAWLS ... has developed that rationale brilliantly, deriving a principle of "equality in the assignment of basic rights and duties" from a theory of the social contract' [OKUN, 1975, p. 14].

Again, unless procedural preferences are subsumed under human dignity, I fail to see how humanism justifies the infringement of efficiency.

According to Encyclopaedia Britannica, humanism refers to 'value systems that emphasize the personal worth of each individual but that do not include a belief in God'. Oxford English Dictionary defines humanism as any 'system of thought or action which is concerned with merely human interests (as distinguished from divine), or with those of the human race in general (as distinguished from individual)'. Webster's Dictionary defines humanism as 'any system or way of thought or action concerned with the interests and ideals of people'. Most people would agree that, ultimately, it is individual welfare (including contribution to other individuals' welfare) that reflects personal worth, interests, and ideals of people. Thus, for the society, humanism is not far from welfarism, the maximization of social welfare as an increasing function of individual welfares. Then, as shown above, even in combination with pluralism, it does not justify the infringement of economic efficiency, except for procedural preferences (called human dignity if preferred). An important reason for this preference may be due to the following consideration.

'In RAWLS' voluntary association, every member wants to ensure the recognition of the principles of self-respect and of fairness for all citizens, because that recognition protects him. The basic liberties are equally distributed because people value equality as a type of "mutual respect ... owed to human beings as moral persons"' [OKUN, 1975, pp. 14–15].

That people value equality and that people have preferences on procedural 'justice', etc. must be recognized. However, the question remains, why absolute equality in certain spheres and economic efficiency (with some tradeoff with equality) in others? Ethical choice made in the 'original position' under 'a veil of ignorance' (as to which member of the society one would become) is not sufficient to answer the question. In fact, this 'veil of ignorance' made famous by RAWLS is due to HARSANYI [1953 and 1955] who used it in conjunction with a number of reasonable axioms of rational choice to obtain the result
that we should maximize social welfare as a sum of individual utilities. Unless absolute equality is consistent with the maximization of this utilitarian objective, the veil of ignorance does not justify absolute equality nor the maximin principle of justice [a critique of which appears as an appendix to NG, 1987].

One possible explanation of the polarization of economic efficiency and absolute equality is the practical difficulties in using economic calculation in certain spheres, to the consideration of this we now turn.

V. PRACTICAL DIFFICULTIES

For ordinary private goods like bread which do not involve significant external costs and consumer ignorance, free market solution is a most efficient way of achieving economic efficiency in their production and distribution. By being prepared to pay for these goods, consumers reveal their true preferences for them at the margin. For public goods, the principle of economic efficiency shall still apply, if practicable. However, short of using the celebrated VICKREY-CLARK-GROVES incentive-compatible mechanism for preference revelation [which is itself besetted with practical difficulties, see NG, 1983, Section 5.4.2 and Section 8.3], we have the free-rider problem in public goods. Because of this and possibly other practical difficulties, many issues are decided politically, possibly according to one-person-one-vote, rather than in accordance to the calculation of economic efficiency. This does not mean that economic efficiency is not desired. Rather, it is unattainable due to certain practical difficulties.

Another area of practical difficulties is the effectiveness of the tax/subsidy system. With significant tax evasion, a given progressive income taxation system may be much less progressive in reality than on paper. In the extreme, we may imagine a poor economy with big disparity in both pre- and post-tax distribution of income despite very progressive but ineffective income taxation system. If it is possible to effect egalitarian distribution of certain goods (e.g. food), it may well improve social welfare despite the infringement of pure economic efficiency. The gain in providing a better standard of living to the poor may more than outweigh the loss in allocative inefficiency and in disincentive effects.
However, if a country is unable to carry out a progressive income taxation system reasonably effectively, its ability to effect egalitarian distribution in specific goods is also suspect. Just as people try to evade income taxes by hook or by crook, they will also try to get round the egalitarian distribution by bribery, ‘walking through the back door’, etc. Unless there is some specific reasons making the practice of egalitarianism through infringing on economic efficiency (including egalitarianism in the distribution of specific goods rather than in general purchasing power), its desirability is highly suspect. However, there is one consideration (which I owe to DAVID KELSEY) that may make the use of non-taxation measures to achieve equality desirable.

Suppose that both the taxation method and the specific egalitarian method are equally ineffective. For simplicity, suppose that each completely succeed half of the time and completely fail half of the time. If these probabilities are not significantly correlated, it may be desirable to put your eggs in both baskets. Assume complete non-correlation, you will then completely fail \( \frac{1}{4} \) of the time, completely succeed \( \frac{1}{4} \) of the time, and half succeed \( \frac{1}{2} \) of the time. It is not difficult to construct cases where this is preferable to putting all your eggs in the slightly more efficient basket (taxation only). However, the advantage of a combined policy depends on significant non-correlation of the success/failure of the two policies and on the equality-oriented policy being not too inefficient relative to the tax/subsidy policy. Secondly, if it is possible to improve upon the effectiveness of the tax/subsidy policy significantly, that is better than spending time, effort and resources to effect the combined policy.

VI. ECONOMICS VERSUS ETHICS

In a recent paper ‘Economists favour the price system – who else does?’, FREY [1986] provides a fairly comprehensive discussion of reasons against the price system, including the following: 1. distributional considerations, 2. destruction of morals, 3. reluctance to engage in trade and perceived unfairness of price rationing, 4. ignorance and vested interests. The first factor has been discussed above; let us consider the last three in turn.

If one adhere to some ethical principles not based on individual
preferences or welfares\textsuperscript{11}, economic efficiency with respect to individual preferences or welfare obviously has to be qualified. For example, Sen [1979 and 1985] attacks welfarism (basing social choice only on individual welfares) as violating such ethical principles as no-torture, non-exploitation, etc. Mishan [1981, pp. 260–262] argued against economic efficiency based on individual preferences for whipping, envy, etc.:

‘For example, a person $B$ may be willing to sell himself into servitude for the rest of his life to person $A$ . . . a poor man $B$ may agree to his being flagellated by a rich man $A$ for a sum that ensures mutual gains. Ignoring externalities, the bargain that could be struck in either case would, of course, meet (the maxim of Pareto efficiency)’ [Mishan, 1981, p. 260].

In my view, there are three reasons justifying banning slavery. Selling oneself into servitude for life is a commitment that could bring hardships for life. While an individual is the best judge of his own interest most of the time, he can also make mistakes from time to time, especially during emotional periods. While we allow most individuals freedom to choose and make mistakes, servitude for life is too big a mistake. On balance, it is in the interests of most individuals to disallow slavery altogether in case they make such a silly mistake at times of unclear mind.

Secondly, there may be certain moral obligations binding individuals to great hardships that could be avoided by making slavery illegal. For example, in traditional China, giving the dead parents a ‘decent’ burial is regarded as a paramount obligation of children. If slavery is not illegal, poor people may find it obligatory to sell themselves into slavery in order to give their deceased parents a ‘good’ but costly burial, even if this decreases their welfare drastically. Making slavery illegal actually makes them better off as they then feel that they had already tried their best to give whatever burial they could to their parents. Thirdly, where many people find slavery disgusting, it also produces an external cost.

All the above three reasons justifying the banning of slavery are consistent with welfarism. Of course, if one is prepared to insist on

\textsuperscript{11.} In the absence of ignorance, irrationality, and a concern for the welfare of other individuals, individual preference and welfare coincide; see Ng [1979, pp. 7–12].
some non-welfarist principle as his ultimate ethical belief not explainable in welfarist terms, he may logically reject welfarism and economic efficiency based on welfarism. However, I believe that I have provided a persuasive defence of welfarism [Ng, 1981 and 1985] and that most people accept welfarism as the ultimate ethical principle.

Allowing mutually agreed exchange on whipping may not only produce external costs but may also directly and indirectly foster attitude undesirable to long-term welfare. Similarly, attempting to take account of the envy-causing effects in cost-benefit analysis does not only create an impossible task of estimation but also encourages people to pretend to be envious and may produce more actual envies in the long run.

If slavery, whipping, etc. would not reduce welfare in the long run, if I would be much happier 12 becoming a slave, I would be the first to volunteer to be a slave 13.

While the undesirable effects of such extreme practices as slavery and whipping are more widely recognized, the negative effects of the general use of the price system and the related pursuit of efficiency on morality is more debatable. As shown by Hirschman [1977 and 1982], 'the exactly opposite view was intensively brought forward from the 16th to the 19th century' [Frey, 1986, p. 556]. According to the 'doux commerce' thesis, the price system is not only efficient in the

12. So much happier as to overbalance my contribution as a free individual towards the welfare of others.

13. Many non-economists are against the inclusion of the benefits to criminals in the cost-benefit calculus of law enforcement. This may be based on the view that the short-term pecuniary benefits to criminals in fact contribute to the long-term pecuniary and non-pecuniary harms to others and to the criminals themselves. Then, provided these indirect costs are properly accounted for, the short-term benefits, if any, need not be ignored; economic efficiency can be preserved. On the other hand, the objection may be based on a kind of vindictive feeling against criminals. 'One who breaks the law puts himself outside the law and, for so long as he does so, outside society. The gains to outlaws from their illicit activities can thus be safely ignored when judging society's welfare ... The gains and losses of outlaws should be irrelevant (to public policy)' [Rhoads, 1985, p. 173 and p. 289]. While this sentiment is understandable, I believe that public policy should maximize the welfare of all concerned, especially if we recognize that, in an important sense, criminals are the less fortunate among us. I am in favour of heavier penalties (even capital punishment) for serious crimes but only for their preventive purposes.
material production but also ‘would generate as a by-product, or external economy, a more “polished” human type – more honest, reliable, orderly, and disciplined, as well as more friendly and helpful’ [HIRSCHMAN, 1982, p. 1465].

Currently, most people seem to believe that the price system is inimical to morality. It is thus not very surprising that the current ‘extreme champions of the price system of the Chicago School (FRIEDMAN and STIGLER) argue exclusively with the efficiency argument and disregard (the) possibility of a positive effect on morals’ [FREY, 1986, p. 556]. They are probably afraid that, once they bring in the issue of morals, they will incur heavy losses.

Whether the use of the price system has, on balance, negative or positive effects on morals is very difficult to judge. What can be said here is that the better one understands economics, the less is the harmful effects associated with the use of the price system. It follows that as the level of understanding by the general public of the efficiency of the price system increases, the optimal scope for the use of the price system also expands.

VII. PERCEIVED UNFAIRNESS AND RELUCTANCE TO TRADE

The reluctance to trade is typified by the following example:

‘Mr. R bought a case of good wine in the late “50”s for about $5 a bottle. A few years later his wine merchant offered him to buy the wine back for $100 a bottle. He refuses,

14. For example, HIRSCH [1976, especially Ch. 10]. HIRSCH’s critics of the market and economic growth is based on: (1) the external costs of positional competition, (2) procedural dispreference for market allocation, and (3) that the market debases moral values. The last two factors have been discussed in the text; the first is not an argument against economic efficiency but that the relevant external costs have to be taken into account. Much of HIRSCH’s argument on positional competition centres around the excessive investment in education due to the purely competitive feature of education as a filter. At best, this calls for a partial offset to the traditional argument for subsidizing education on the ground of external benefits rather than limiting the role of the market. Incidentally, the case against free education is strengthened by the fact that students work harder and value their education more if they have to pay some tuition fee. In most Western countries, my judgment is that most students work less hard than socially optimal rather the other way round.
although he has never paid [and would not pay] more than $35 for a bottle of wine' [THALER, 1980, p. 43].

Though the difference between buying and selling price may be explained in the orthodox way by introducing income effects, transaction costs, and/or game strategic behaviours, FREY [1986, p. 548] dismisses these as either unconvincing or ad hoc for the wine example. It is true that if we include the cost of going against the reluctance to trade into transaction costs, the orthodox explanation need not be unconvincing, but it then becomes almost tautological.

But why should people be reluctant to trade? In the wine example, it may be due to the following consideration. Except for items subject to customary resale, e.g. second-hand cars, shares, having to sell something one already possesses may be distasteful since it may be regarded as a sign of desperation.

In addition to the above consideration, if an item is regarded as of special significance to an individual, family, or nation, its sale may be especially distasteful. This explains the 'reluctance in all countries to sell art to foreign lands, in particular when it is considered to be part of the “patrimoine national”' [FREY, 1986, p. 551].

Reluctance to trade due to the above considerations need not be a serious impediment to the calculus of economic efficiency; it just means that the reluctance has to be taken into account. A more serious problem arises with respect to the perceived unfairness of price rationing. This is typified by the fact that 82% of a randomly selected residents of Toronto and Vancouver found it to be unfair for a hardware store to raise the price of a snow shovel from $15 to $20 after a heavy snowstorm [KAHNEMAN, KNETSCH and THALER, 1986, p. 729]. However, as argued below, this may be due to the ignorance of the respondents rather than their basic belief.

VIII. IGNORANCE OF ECONOMICS

The fact that most economists accept price rationing as fair and most non-economists don’t suggest that the divergence may be due to the ignorance of non-economists on the efficiency of price rationing and on the fact that distributional equality can be better pursued by gener-
al taxation policy than through specific intervention of the market. If the general public are convinced of the efficiency of the price system, they may have a more favourable attitude towards price rationing. To test this hypothesis, I undertook a small survey \(^{15}\). A somewhat random sample of people of different ages and sexes are asked to consider the following:

*Question A*: A restaurant has become very popular and reservations for dinner on Saturday night have to be made well in advance. The restaurant owner informs all customers requesting reservations for Saturday night that from now on there will be a seating charge of $8 per person for all Saturday night reservations . . .

Out of 82 persons, 24 (29\%) believe (assuming they ticked what they believe) it is completely fair or acceptable, and 58 (71\%) believe it is unfair or very unfair for restaurants to impose seating charges. Next, subjects (same set) are then asked to consider:

*Question B*: An economist explains that seating charges for Saturday night help to allocate the scarce dining seats over peak hours more efficiently, saving people the trouble of having to book well in advance or suffering disappointment. They encourage those who do not particularly care which day in the week to dine out to choose nights other than Saturdays. It is costly to expand seating capacity, and capacity is already under-utilized except on Saturdays. Hence, charging extra for Saturday dining is, in principle, no different from charging extra for more expensive cars \(^{16}\). Moreover, if restaurants charge seating fees for peak-hour dining, competition among restaurants will help bring down the level (or its rate of increase) of prices for off-peak dining (i.e. other than Saturday night). In other words, the prices of dishes (for Saturday and other days alike) would be

\(^{15}\) Due to the small sample and that the control for randomness is not perfect (people are randomly interviewed in the streets and shopping centres), our result should be taken as indicative than conclusive. It should also be noted that Question A below is taken from KAHNEMAN, KNETSCHE and THALER [1986].

\(^{16}\) These two sentences are added half-way through the survey, after a subject insisted that restaurants should expand capacity rather than imposing seating charges. I expected this slight addition to increase the learning effect significantly; it did not.
lower in the presence of seating charges for Saturday nights...

After reading this explanation, 41 (50 \%) believe it is completely fair or acceptable, and 41 (50 \%) believe it is unfair or very unfair. There are 18 persons (31 \%) changing their rating from unfair into fair and only one changed the answer the other way round\textsuperscript{17}.

It is even more revealing to compare the responses to the above Questions A and B by the general public, by a group of first-year science students (n = 43), first year economics students (after only two to three months of training; n = 34) and by a group of fourth-year economics students (n = 27). It is important to include first-year as well as fourth-year economics students to see if there is any significant difference after learning economics as such as distinct from the perception of those who choose economics as a career versus the general public\textsuperscript{18}.

The weighted average indices of perceived fairness reported in the last row are calculated by allocating the indices of 2, 1, −1, −2 respectively to ‘Completely Fair’, ‘Acceptable’, ‘Unfair’, and ‘Very Unfair’ respectively and summed over after multiplying these indices with the respective percentage points. (Similarly for Tables 2 and 3 below.)

From Table 1, it is clear that:

(1) Economics students have a more favourable fairness perception of seating charges than the general public;

(2) Fourth-year economics students are more so than first-year economics students;

(3) While economics students are to the ‘right’ of the general public, science students are to the ‘left’ of the general public. First year students as a whole is not significantly different from the general public in their perception of fairness.

\textsuperscript{17} Initially, I have an extra question: ‘Since Saturday nights are most popular for restaurant dinners, many restaurants impose seating charges for Saturday nights ...’. All subjects ticked the same answers for the question as for Question A. In fact, several commented that they are the same. This ensures that the shift in answers between Question A and Question B is not due to the difference between a single restaurant imposing seating charge and a general practice of seating charges.

\textsuperscript{18} There is some evidence that those who choose economics are somewhat different from the general population in certain aspects, e.g. they free-ride more than the general population; see Marwell and Ames [1981]. Rhoads [1985, pp. 162–163].
(4) All groups register a significant 'learning effect', i.e. their perception of fairness increases after reading the one-paragraph economics contained in Question B.

It may also be noted that the perception of 1st-year economics students are closer to the general public than to the 4th-year economics students, suggesting that the difference in perception of fairness of the price system between economists and non-economists is substantially explained by the learning of economics rather than just by

Table 1

Differences in Perception of Fairness by Science and Economics Students and the General Public
(in percent)

<table>
<thead>
<tr>
<th>Question A</th>
<th>Question B</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td>1st yr</td>
</tr>
<tr>
<td>Competely Fair or Acceptable</td>
<td>29.3</td>
</tr>
<tr>
<td>Unfair or Very Unfair</td>
<td>70.7</td>
</tr>
<tr>
<td>Weighted Average Index*</td>
<td>-62</td>
</tr>
</tbody>
</table>

*calculated in accordance to four classifications

Table 2

Insignificance of High School Economics
(in percent)

<table>
<thead>
<tr>
<th>Question A</th>
<th>Question B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Some Training</td>
<td>No Training</td>
</tr>
<tr>
<td>Completely Fair or Acceptable</td>
<td>28.6</td>
</tr>
<tr>
<td>Unfair or Very Unfair</td>
<td>71.4</td>
</tr>
<tr>
<td>Weighted Average Index*</td>
<td>-60</td>
</tr>
</tbody>
</table>

* see Table 1
ECONOMIC EFFICIENCY VERSUS EGALITARIAN RIGHTS

Table 3

Differences in Perception of Fairness by Age Groups
(in percent)

<table>
<thead>
<tr>
<th></th>
<th>Question A</th>
<th>Question B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completely Fair or Acceptable</td>
<td>50.0</td>
<td>23.8</td>
</tr>
<tr>
<td>Unfair or Very Unfair</td>
<td>50.0</td>
<td>76.2</td>
</tr>
<tr>
<td>Weighted Average Index*</td>
<td>0</td>
<td>-76</td>
</tr>
</tbody>
</table>

*see Table 1

the difference between the two groups of people before the learning effect.

The result reported above supports the belief by a political scientist that 'some knowledge of contemporary microeconomics is a prerequisite for intelligent citizenship' [RHOADS, 1985, p. xi]. However, unless we can do better than just high-school economics taught by teachers mostly not very proficient in economics and with some anti-market bias themselves, we are unlikely to gain much. As reported in Table 2, there is no significant difference between the groups of the general public that report some (high-school level) training in economics and that report no training. If anything, those with no training register marginally (not significant) higher learning effect.

While there is no significant difference between those with no training and those with some training in economics, there is a lot of difference between different age groups of the general public (not including the three groups of university students), as reported in Table 3.

Clearly,

(1) the very young (under 21) start off with a more favourable view of seating charge;
(2) all age groups except the over 55 register big learning effects;
(3) the over 55 register no learning effect.
These results are perhaps not surprising, given one's stubbornness as one gets older. If we exclude the over 55 on the ground of their psychological difficulty in learning associated with their old age, the learning effect of the general public becomes substantially bigger.

A subject told me that it is O.K. for restaurants to charge higher prices (for dishes) on Saturdays (‘higher demand, higher prices, it’s O.K.’) but unfair to call it ‘seating charge’. I told him that whatever you call it, effectively it is the same. But he insists that seating charges are unfair. It seems that people’s concepts of fairness are shaped by tradition, culture, etc. in such a way as to be dogmatic, irrational, or simply wrong, at least in the eyes of the economist.

The modern economy is too complicated for non-economists to understand. Just as we have to call in experts to deal with nuclear reactors, the society should consult economists even on apparently purely ethical questions of fairness, at least for those that are related to economic issues. However, what should be may be different from what is and what will be. Actual political decisions may be more influenced by vested interests, pressure groups, and political entrepreneurship. While economists have much to learn about these and related issues to make their recommendations practically more effective [NELSON, 1987 and RIVLIN, 1987], this is beyond the scope of the present paper.

IX. CONCLUDING REMARKS

From our brief discussion above, it seems that two most important considerations justifying the infringement of economic efficiency are procedural preference and the ineffectiveness of income taxation. With better understanding of the role of economic efficiency, especially of the argument for treating a dollar as a dollar, the importance of procedural preference may decrease but is unlikely to become insignificant. With the improvement in the effectiveness of income taxation, as a country develops in terms of its rule of law, tax obeyance and detection, the effectiveness of its income taxation system may improve significantly. This will make it less necessary to rely on efficiency-infringing methods to achieve equality. The sphere
in which the calculation of economic efficiency dominates may then be allowed to expand. Many people deplore the fact that the economic domain has taken over more and more spheres formerly not subjected to trade and economic calculation. According to our analysis, this may well be a sign and result of applaudable progress.

REFERENCES


The domain of rights is full of infringements on efficiency. Apart from practical difficulties, ignorance, irrationality, and preference for inefficient procedures, are there considerations justifying such infringements? Egalitarianism does not provide a valid justification; the argument for “a dollar is a dollar” shows that equality is better pursued by income taxation, even taking account of disincentive effects and second-best complications. This argument is generalized to cover non-economic issues. A survey of people’s view of fairness shows that objection to efficiency is usually based on inadequate understanding of economics. Improvements in the effectiveness of income taxation and in public understanding of economics justify an expansion in the economic domain where efficiency dominates.
ECONOMIC EFFICIENCY VERSUS EGALITARIAN RIGHTS


RÉSUMÉ

Les infractions au bon rendement sont nombreuses dans le domaine des droits. A part les difficultés pratiques, l'ignorance, l'irrationalité et la préférence pour des procédures inefficaces, certaines considérations justifient-elles de telles infractions? L'égalitarisme ne fournit pas de justification valable; l'argument que «un sou est un sou» démontre que la poursuite de l'égalité est mieux réalisée par l'imposition des revenus, même si l'on tient compte de l'effet de démobilisation et des complications du 'second best'. Cet argument se généralise dans les questions non économiques. Un sondage d'opinion sur ce qui est juste montre que les objections au rendement sont d'habitude basées sur une compréhension insuffisante de l'économie. Des améliorations de l'efficacité de l'imposition sur les revenus et de la compréhension de l'économie par le public justifient une expansion dans le domaine de l'économie où le rendement domine.