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Economics

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A core contribution of Economics to public decision-making is a concept of efficiency

Economics has been called a *dismal science* since the late nineteenth century. The name is intuitive. There are not enough resources to satisfy all our material needs and the allocation of scarce resources between competing needs is the main subject of Economics. Not surprisingly, economists often produce recommendations that dismay at least some of the interested parties.

Nowadays the problem of scarcity is more acute. For present-day generations the extinction of species, overfishing, environmental depletion and climate change, according to the scientific consensus on the origins of global warming, require actions that were not considered in the nineteenth and for most of the twentieth centuries. In Victorian times, scientists even argued that the fish was so abundant that it was enough for everyone who could catch it.

To address scarcity, a core contribution of Economics to public decision-making is a concept of efficiency. Another is the argument that competitive markets are the most appropriate way to promote efficiency. The Kaldor-Hicks concept of efficiency, which currently predominates in welfare economics or in the economic theory of regulation, has been accepted by legislators in many areas, such as sectoral regulation, competition policy, and public policy. However, there are reservations about its use. One is based on the dependence of the concept of efficiency on the income distribution of the society under analysis. We get the idea, but it doesn’t invalidate the criterion. The efficiency criterion requires the decision-maker to look at the impact of their decision at the society where it will be imposed, as it exists, and not at an ahistorical alternative. The absence of mandatory compensation is another source of reservations, which must also be kept in mind, but without invalidating the criteria, especially since in practice the absence of compensation may result from the impossibility of estimating the value of the damage suffered by each one.

When dealing with unique resources, e.g., some environmental resources, the concept of efficiency is less useful, as it does not take into account the interests of future generations. There are alternative criteria in the economists' toolbox, such as sustainability or the precautionary principle, the latter enshrined in the Treaty of Lisbon. The application of this criterion in the policy response to risks of systemic financial crisis, or natural or geopolitical catastrophes is arguable.

Recently, behavioural economics has relativized the economic concept of efficiency, because the hypotheses of unlimited rationality implicit in it do not fit the way people behave. Thus, the way has been paved for new public policies, e.g., to promote savings and consumer protection. But, colliding with the principle of consumer sovereignty, it incentivizes the paternalism of the State. In this context, it is worth remembering that the economic analysis of the political process highlights the risk of political opportunism and the costs that result from it. It is not guaranteed that the political process will result in a benevolent State.

There are various robust explanations about the social benefits of competitive markets, from the first theorem of welfare economics, valid under very restrictive conditions, to the general defence of the market as a process of information discovery, in the Austrian tradition, or to historical evidence.

At the same time, it is well-known that markets are often inefficient, there are market failures, which provide a rationale for government regulation. As a matter of fact, government regulation is an indispensable condition for the market economy. Moreover, state intervention predates the very idea of the market, because without a legal framework defining property rights, the rules to be complied with by the agents, and the police and courts that enforce them, a market economy is not viable.

The market economy creates many areas of discussion between economists, public decision makers and other interested parties. One is to define the activities that should be excluded or included in the market. At stake is a social decision, not an economist's decision.

Do we accept the existence of a market for psychotropic substances? Or human organs? Tobacco was once recommended for health reasons and now it is on the threshold of illegality also for health reasons, well--found now, unlike before. A little more than 200 years ago, a movement began to abolish slavery, and the corresponding markets, that nowadays most people would consider the most repulsive markets in the history of human activities.

Having said that, economists are not neutral about the market, if an activity is recognized as legal. Typically, they defend that it is the best way to organize the activity, and they have made remarkable contributions to the creation of new markets. Wholesale electricity markets provide a recent successful example. Another is the creation of regulated markets for carbon emission permits. These have been subject to some contention, because they have been wrongly understood as allowing people to pay to avoid the burden of pollution control. That is not the case. The creation of regulated carbon markets, the European one being the most important, ensures that the objective of reducing emissions, established politically, is achieved at the lowest possible cost. It is certainly better than what would be achieved by imposing administrative rules on carbon emissions.

Inequality in the distribution of income is another area where the dialogue between economists, public decision-makers and other actors may not easy. It does not have to be like that. Under the second theorem of welfare economics, as long as society chooses the distribution of wealth, an efficient allocation of resources can be achieved through competitive markets. Regardless of the very restrictive conditions in which the theorem applies, what is not always recognized is that it is not up to economists to define what is the best distribution of wealth. It is up to the voters and if they do not agree on the subject, it's not the economists' fault.

Incentives are another issue. The sad view of human nature inherent to *homo economicus* requires incentives to align individual and collective interests. But in practice there can be counterproductive effects. For example, paying someone to donate blood can lead to a reduction in their contribution, so that it doesn't look like they want to make money from it.

A big advantage of a market economy is its price-driven ability to respond to technological or political shocks, shifting the allocation of resources according to the new sets of relative prices. This was the case for innovations such as electricity or the digital revolution, or for the shocks induced by globalization. Hopefully, it will be the case of artificial intelligence. However, Economics is less conclusive about the speed at which markets adjust or about the consequences of the adjustment process on the geographical distribution of economic activities. The relevant geographical areas rarely coincide with the countries, and this is a natural source of tension in the dialogue between national governments and economists driven by an efficiency criterion. In the same sense, it is a political problem, not an economic one, to decide, for example, whether small marginal societal gains, resulting from more globalization, compensate for subsequent local crises. Sensible economists may try to understand the political point of view.

All along, Economics has been contributing to a better understanding of technological progress, which is the very successful means that humans have found to alleviate the problem of scarcity. But we will always have scarcity. More likely than not, economists will continue to enjoy being called practitioners of "*the dismal science*."

References

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