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# Truth or Economics: On the Definition, Prediction, and Relevance of Economic Efficiency

PG Allen

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## Book review

**Truth or Economics: On the Definition, Prediction, and Relevance of Economic Efficiency, Richard S. Markovits. Yale University Press, New Haven (2008). x+507 pp.**

The author introduces his monograph by noting in the first paragraph that (p. 1): “This book is a constructive critique of the way in which economists and law and economics scholars define, predict, and assess the moral and legal relevance of the impact of private choices or government policies on economic efficiency”. Efficiency of any kind is a slippery concept. What the author deals with is summarized in the concluding chapter (p. 421): “The book’s three parts respectively address the following three issues: the correct way to define the impact of a choice or policy on economic (allocative) efficiency, the most-allocatively-efficient way to assess the allocative efficiency of a choice or policy, and the connection between allocative-efficiency conclusions and prescriptive-moral and legal conclusions”. These two sentences, which are among the easier parts of this highly specialized book for a lay economist to grasp, serve to illustrate the dense, highly technical nature of the author’s arguments. Serious welfare economists are unlikely to find a better organized or more persuasive presentation on measuring the impact of a policy change on individual or group welfare. And only serious-minded welfare economists will persevere through all 436 pages of text, containing many in-excess-of-fifty word compound-adjective sentences. (There are another 50 pages of endnotes.)

The title of this book suggests a dichotomy: truth-seekers and economists are two different animals. This is indeed the author’s intent. At least as far as welfare

economists are concerned, the author maintains that in measuring the impacts of a policy, they use approaches they know to be wrong. The subtitle conveys a partly correct impression. There are some 50 pages on the definitions of allocative efficiency, and a fair amount on relevance from a philosophical and legal standpoint. One must look hard for anything on prediction, or at least anything that a forecaster would consider germane. The bulk of the book, a chapter of almost 200 pages, is on the measurement of allocative efficiency, particularly in the typical context of second-best situations. Faced with an unavoidable market failure in one part of the economy – for example, a monopoly – should we attempt to attain perfect competition in the rest of the economy – a next best solution? We already have the answer: under the general theory of the second best, achieving perfect competition in the rest of the economy is not, in general, the most desirable response to market failure. The author finds two attitudes among economists: those who know the theory of the second best but choose to ignore it in their analyses, and those who do not know the theory of the second best and don’t care. The book is a manifesto to show both groups why they should care and how they can amend their analyses.

And finding the second-best solution in a typical economy with many market failures is both difficult and time consuming. In the chapter, the author lays out an approach for dealing with distortions caused by market failure to arrive at a third-best solution, rather than the impossible-to-achieve second-best solution. That is, since the complete analysis takes too much time and resources (like labor), make a judgment about how much time and resources are worth devoting to analyzing the effect of a policy, then calculate the distortion-reducing impacts of the policy to the extent that it is judged worthwhile — a partial analysis.

Most economists will readily accept the author's fundamental contention, that the correct way of measuring welfare changes is through equivalent variation. Having got that far, most will probably fall back on the Willig (1976) defense. Willig argued that although consumers' surplus, compensating and equivalent variation are all different values, for most practical situations the difference among them is small. He may not have said so explicitly, but his implication was that the errors in measuring variables, choosing an appropriate functional form and estimating parameters will matter more than the correct choice of welfare measure. Forecasters should readily appreciate Willig's argument.

Markovits' book, if incorrect in detail, is surely a methodological improvement. Concerning policy analysis, he provides numerous arguments as to why the standard Pareto, Kaldor-Hicks, Scitovsky and potential Pareto measures of a welfare change are inadequate. He quotes seven or eight arguments used by economists for ignoring second-best considerations and provides several counters to each. With a lawyer's skill, Markovits has marshaled his arguments as to what is wrong with current practice, why it is wrong and what needs to be changed. Does he convince me to persevere? No. The additional amount of work to analyze a policy seems high. How different will the results be in practice? We don't know.

At one point (p. 70), the author admits that the difference between compensating and equivalent variation might be of the order of two to three percent, and attempts to rebut those who (like me) believe that

these differences are too small to worry about. His arguments include: small, but why not do it right? Small, but in the context of a national policy this might be \$20 million to \$30 million; small, but how can you be sure it is as small as you say? There is no quantitative example applied to a real-world situation. That would be a good first step, though of course it raises additional questions, such as, under what conditions is the difference likely to be large enough to matter? For that we await a latter-day Willig. But first, the author must convince at least a handful of economists to adopt his approach, and, as he makes clear, he is at present a lonely pioneer.

## References

Willig, R. D. (1976). Consumers' surplus without apology. *American Economic Review*, 66, 589–597.

**P. Geoffrey Allen** is Professor Emeritus in the Department of Resource Economics. His research is on various aspects of decision-making under uncertainty, with his current research interests focusing on econometric forecasting and time series analysis in general. The philosophy is that better decisions will arise out of better forecasts and better forecasts will result from using improved strategies when specifying structural economic models. A related topic is information assembly, which includes the duplication of published results, the use of different tests or data sets with existing models, and the extraction of conclusions from groups of related studies or meta-analyses.

P. Geoffrey Allen  
*Resource Economics, University of Massachusetts,  
Amherst, MA, United States*  
E-mail address: [allen@resecon.umass.edu](mailto:allen@resecon.umass.edu).