Appendix 3: Some economic terms

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Extracts from:

Bannock G, Baxter R & Rees R, *The Penguin Dictionary of Economics*, Penguin, Harmondsworth, 3rd ed. 1984

Pearce D W ed., *The MIT Dictionary of Modern Economics*, MIT Press, Cambridge Massachusetts 1986

consumer's surplus

`The excess of the amount a consumer is prepared to pay for a good (rather than go without it) over the amount he actually does pay for it....' [Bannock et al. 1984]

economic efficiency/ allocative efficiency

`The production of the `best' or optimal combination of outputs by means of the most efficient combination of inputs. `Optimal' output might be determined in various ways, but in welfare economics it is generally held to be that output combination which would be chosen by individual consumers responding in perfect markets to prices which reflect true costs of production. The efficient combination of inputs is that which produces output at the least opportunity cost...' [Pearce 1986]

economic welfare

`That part of human welfare which results from the consumption of goods and services.... Although welfare was originally regarded as being synonymous with satisfaction or utility, some economists have objected that welfare is an ethical concept in that to say that the satisfaction of an individual's desires increases his welfare is to make a value judgement that the satisfaction of those desires is a good thing. Other economists would persist in arguing that `economic welfare' has a precise meaning and has no ethical overtones. Further difficulties and limitations arise when we wish to measure welfare... In attempting to resolve these difficulties, economists have employed the concept of a social welfare function which seeks to relate the welfare of a given group to that of the individuals composing the group...' [Pearce 1986]

externalities

`Externalities in consumption exist when the level of consumption of some good by one consumer has a direct effect on the welfare of another consumer, an effect which is *not* transmitted through the price mechanism... Examples of consumption externalities are: 1. A, wanting privacy, builds a high fence, which reduces the amount of sunshine flooding in through B's window; 2. A, in making a right turn on a busy road, causes a large traffic jam to build up behind him...

`The essence of externalities... is that their costs or benefits are not reflected in market prices, so the decision of the consumer or firm creating the externalities on the scale of the externality-creating activity does not generally take its effect into account. Hence, since the time of A C Pigou, economists have argued that social welfare would be increased if the private consumption or production decision were modified so as to take the external effect into account. The means of doing this were traditionally held to be the imposition of taxes on activities which created losses in welfare or increases in costs, and payment of subsidies on activities which increased welfare or lowered costs...' [Bannock et al. 1984]

`Externalities are variously known as external effects, external economies and diseconomies, spillovers and neighbourhood effects...' [Pearce 1986]

marginal cost

`The extra cost of producing an extra unit of output.... marginal cost is determined by variable costs only. In the long run marginal costs may rise, fall or stay constant depending on the presence of economies or diseconomies of scale.' [Pearce 1986]

`The increase in cost resulting from a small increase in the rate of output of a good or service.... It is necessary to distinguish between short-run and long-run marginal cost. Suppose the firm is deciding upon its output levels for the coming month. Although it will be able to vary the quantities of some of the factors of production it uses, for example, energy, raw materials and some kinds of labour services, there will factors whose quantities cannot (or would be prohibitively costly in such a short period) vary, for example its stock of machinery and buildings, and perhaps some kinds of highly skilled labour. It must then calculate the cost of changes in output, taking into account the fact that only some of its inputs are variable. The corresponding marginal cost is then a short-run marginal cost. Suppose on the other hand that the firm is planning output for a month so far into the future that, over the intervening period, it is possible to change *all* input levels. For example, it is long enough for the firm to plan, buy and install more machinery, construct new buildings and hire or train the skilled labour, It can then calculate the cost of changes in output in that future period on the basis that all inputs are variable, and the associated marginal cost will be long-run marginal cost.

`The relevant marginal cost to use is always unambiguous: it is determined by the precise period for which output is being planned and the possibilities of varying inputs for that period.' [Bannock et al. 1984]

marginal cost pricing

`A pricing practice pursued by private firms or public corporations in which price is made equal to marginal cost.... In the public sector, nationalized industries are recommended to use marginal cost pricing, the rationale being that it maximizes economic welfare.' [Pearce 1986] *[see also `non-rival consumption']*

`A method of setting price, by which the price at which an output can be sold on the market is equated with the marginal cost of producing that output...

`Marginal cost pricing is often recommended as an appropriate policy for public enterprise and regulated industries, on the grounds that it is the pricing policy which maximizes social welfare... The marginal cost of the good shows the value of the resources absorbed in producing the marginal unit of output, and hence the value of the other goods and services which the economy could have produced with those resources. Now, if price and output were chosen such that price exceeded marginal cost, that would mean consumers place a higher value on the marginal portion of their consumption than it costs to divert resources from other uses to produce that portion. It would therefore be possible to increase *net* consumer benefits in the economy by supplying more of the output. Thus no price greater than marginal cost can be consistent with maximizing net consumer benefit or social welfare. Likewise, if price and output were such that marginal cost exceeded price, the value of the resources absorbed in producing the marginal portion of output exceeds consumers' valuation of that output, and net benefit can be increased by reducing output. If it is not to be possible to make such welfare-increasing output adjustments, it is necessary that price be set equal to marginal cost.

`Clearly, the whole argument rests on two underlying propositions: a) that output price is a correct measure of the benefit consumers derive from their marginal consumption, and b) that marginal cost is a correct measure of the value of the resources absorbed in producing the marginal bit of output. If one or both of these propositions is *not* true, the `marginal cost pricing rule' may have to be modified. [Bannock et al. 1984]

merit good

`A good the consumption of which is deemed to be intrinsically desirable. In the case of such goods it is argued that consumer sovereignty does not hold and that if consumers are unwilling to purchase `adequate' quantities of such goods they should be compelled or encouraged to do so.... Many economists would reject this reasoning but in any case there is a difficulty in determining who is to decide which goods are merit goods....' [Pearce 1986]

`...It should be noted that there is an element of paternalism in policies towards merit goods. Society decides that the preferences of individuals cannot be left to determine the levels of consumption of such commodities.' [Bannock et al. 1984]

mixed good

`Goods, the benefit of consuming which is neither confined solely to one individual nor available equally to everyone. A mixed good thus lies between the polar extremes of a private good the consumption of which is rival (ie one person's consumption precludes anyone else benefiting from the same unit) and a public good which is non-rival in consumption (the benefits of the good are equally available to everyone), containing elements of both. For example, inoculation against disease is a mixed good since it benefits the community at large (by reducing risk of illness) as well as the individual, though the benefits are not equally distributed. In such cases, private consumption confers a beneficial externality on the rest of the community... Mixed goods are certainly more common than pure public goods and possibly more common than private goods - thus their analysis is of great importance....' [Pearce 1986]

non-rival consumption

`When one individual's consumption of a good in no way diminishes the supply of that good to other individuals, the good is said to be non-rival in consumption. There is no opportunity cost of consumption of such a good. Non-rivalness is a characteristic of public goods. An example of a good which is non-rival in consumption is a broadcast television signal; one person's use of that signal does not diminish its availability to other individuals. Economists generally argue that goods which are non-rival should be provided at zero price for marginal or incremental units, on the grounds that if an additional unit of consumption can be provided at zero cost then that consumption should not be prevented by the charging of a price.' [Pearce 1986] *[see also `marginal cost pricing']*

opportunity cost

`Perhaps the most fundamental concept in economics, the opportunity cost of an action is the value of the forgone alternative action...' [Pearce 1986]

Pareto improvement

`A reallocation of resources which makes at least one person better off without making anyone worse off.... Despite its analytical importance, the Pareto criterion is highly restrictive since it provide no guidance to choice between alternatives which involve one person becoming better off at the expense of another. Since almost any economic policy will act to someone's disadvantage, this is a serious restriction. In order to overcome this, some economists have sought to supplement the Pareto criterion with criteria based on distributional equity while others have considered the use of compensation tests... A `potential Pareto improvement' exists when the gainers from a change are hypothetically able to compensate those who lose, so that it is possible for no-one to be any worse off after the change and for at least one person to be better off.' [Pearce 1986]

price elasticity of demand

`...the percentage change in demand that occurs in response to a percentage change in price...' [Pearce 1986]

public good

`A commodity or service which if supplied to one person can be made available to others at no extra cost. A public good is this said to exhibit non-rival consumption: one person's consumption of the good does not reduce its availability to anyone else... The extreme or `polar' case of a `pure' public good has been defined by Paul A. Samuelson as a good which is: 1. non-rival in consumption; 2. has the characteristic of non-excludability - that is, if the good is provided the producer is unable to prevent anyone from consuming it. This latter characteristic prevents private markets from functioning since a seller would be unable to ensure than only those individuals who paid for the good could obtain it... Where exclusion is possible or where consumption is not completely non-rival we have an example of a mixed good (or impure public good)...

`Where consumption of a good is non-rival, the charging of a price for the good or service is, in terms of the Pareto principle, inefficient. This is so because adding an extra unit of consumption provides a benefit to the consumer without imposing any costs, while the charging of a price would prevent some consumption from taking place - thus causing a net loss of satisfaction or utility. It follows that, even when it is possible, the provision of a public good through a private market will not enable the best or `optimal' level of output to be produced. As we have seen, in the case of non-excludability, a market cannot operate at all.

`The provision of a public good is a matter of collective choice. Generally, we expect to find public goods provided by governments and paid for through compulsory taxation. An alternative solution would be for all the members of a community to make a voluntary agreement to provide and pay for the good. The difficulty with this solution is that individuals may conceal their true valuation of the good in order to escape payment (ie they may seek to be free riders)....'

`Examples of public goods include national defence, street lighting, and environmental protection...' [Pearce 1986]

`Goods which, because they cannot be withheld from one individual without withholding them from all, must be supplied communally. For example, it would not be possible to exclude any one individual from `consuming' national defence, street lighting or general police protection.... Since the state can raise revenues by taxation, it alone can finance the provision of public goods... Note that this definition does not apply to *all* goods publicly supplied. Many of the goods supplied by the state could be supplied privately, and some indeed are; the best examples being housing, education and specific police protection. The non-pure, or `quasi' public goods, are supplied by the state and financed out of taxation because it is considered that their quality and/or quantity of supply would be inadequate under private provision.' [Bannock et al. 1984]

social welfare

`The well-being of the society or community at large. In defining social welfare we face two sets of problems. The first problem concerns the `social' aspect. In general, social welfare is seen as some aggregation of the welfare of individual members of a society - this raises the question of how the aggregation is to be achieved. The second problem relates to the concept of `welfare'. I M D Little has argued (see his *Critique of Welfare Economics*, 2nd ed., Oxford University Press, Oxford 1957) that `welfare' is an ethical concept since to define something as contributing to welfare is to make a value judgement about whether that thing is good or bad. Alternatively it has been argued that welfare should be equated with the satisfaction of individual preferences and regarded as a `technical' term...' [Pearce 1986]

utility

`Widely construed in economics to be synonymous with `welfare', economic welfare, satisfaction and, occasionally, happiness. More strictly, however, to say that someone derives utility from a good or event is to say that they prefer the good to exist rather than not to exist...' [Pearce 1986]

willingness to pay

`The valuation placed by an individual on a good or service in terms of money. Its use as an indicator of valuation is controversial in two respects. First, it will be constrained by ability to pay so that those with higher incomes will appear to value goods more highly than those with lower incomes. This may contradict some concept of fairness or justice. Secondly, it is open to moral objection when the good in question is the removal of a nuisance such as noise or pollution, since it might be argued that it is unjust that the sufferer should have to pay for the removal of the nuisance, when most people would expect that the sufferer should be compensated by the wrong-doer.' [Pearce 1986]

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