Efficiency and Effectiveness in Evaluation of Practices

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Origin of the concept

- Neoclassical economics (utility), welfare economics;
- Originally only **efficiency** – simultaneously included *allocative efficiency* within markets and *income distribution* connected with it;
- However, this would produce rather different conclusions about 'efficient' social welfare, including such distributions leading to deep income and wealth inequalities;
- *New Welfare Economics* – distinguished **efficiency** and **effectiveness (equity)**;
- Efficiency is connected with markets, correct use of scarce public sources, public savings – basically common concept for all economic systems; ***universal/objective***;
- Effectiveness/equity is connected with income distribution, social justice, social inequalities – basically very diverged concepts according to prevailing welfare state; ***particular/normative***;
- Common trade-off situations: interventions may be very *effective* (decreasing inequality) but *inefficient* (making distortions on housing market).

Efficiency

- The *efficiency* is defined through W. Pareto lens:

  „if any alternative allocation of goods increases utility from consumption for at least one actor on the market and at the same time does not decrease utility from consumption for other actors then we say such allocation is inefficient;"

- **Examples** of failure:
  - the existence of oligopoly or monopoly in finance or production;
  - asymmetric information;
  - **public subsidies that crowd out the private investments** (when the state spends tax-payers' money for production goods or services that could be allocated similarly by private entities) or **when alternative subsidy settings can produce public savings** under the same quality.

Effectiveness

- The redistribution of wealth forms a crucial part - attaining ‘fair’ or ‘desirable’ income and wealth distribution;
- ‘Fair’ income/wealth distribution is based on particular social norms, normative concept of welfare state.

BUT

- common shared assumption that whatever redistribution of wealth is finally applied, it should decrease social inequality in society;
- redistribution policies should help the worse-off with the costs of the better-off.

Two types of effectiveness

- Welfare economics distinguishes between ‘vertical’ and ‘horizontal’ effectiveness:
- ***Vertical effectiveness*** measures the degree of redistribution of income, consumption and wealth from the rich to the poor. In the case of particular subsidy (practice) it measures the extent to which such subsidy is **actually allocated to those who really need help, that is to low-income households**.
- ***Horizontal effectiveness*** is connected with the idea of setting a minimum standard of consumption (income, wealth) that would be ensured for all members of society, as well as with the assumption that all needy (poor) households have access to subsidies, that is none of the poor (needy, low income) are excluded from such redistribution. In the case of particular subsidy (practice) it measures whether **any needy (poor) household is not eligible to apply for the subsidy.**
- Some needy households are excluded from subsidies because, for example, the programme has been set up badly or the potential claimants are badly informed.

Assumptions used for evaluation of practices

For *effectiveness* the assumptions are as follows:

- ***Main assumption 1****: Effective subsidies assist lower-income (needy) households more than higher-income (less needy) households. (Vertical effectiveness)*

- ***Main assumption 2****: Effective subsidies do not exclude any lower-income (needy) household. (Horizontal effectiveness)*

For *efficiency* the main assumption is, as follows:

- ***Main assumption****: Subsidies are efficient when it is not possible to meet redistributive goals in a less costly way, that is, under an alternative setting of the subsidies.*

Public spending should be directed to those in need and no needy household should be excluded from the public help. Policies should not waste public money and offer real value-for-money.