Department of Economics, Patna University,Patna

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Module 4: Welfare Economics

Topic: The Kaldor-Hicks Compensation Principle

e-content By: Randhir Kumar, Assistant Professor (Guest faculty)

Email: randhir.deadstair001@gmail.com

Mob: 9835250101

The Kaldor-Hicks Compensation Principle

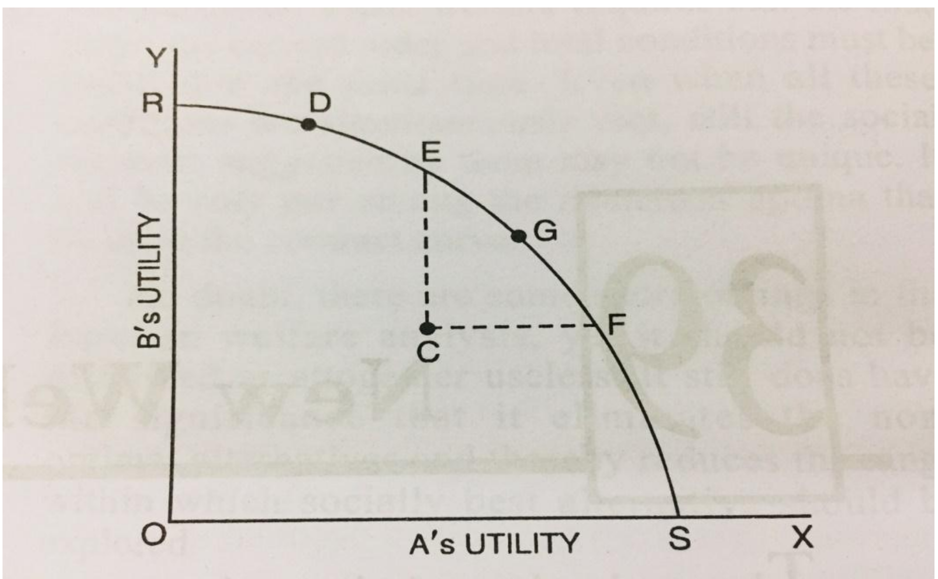
Nicholas Kaldor and J.R.Hicks put forwarded the welfare criterion based upon the compensating payments in 1939. *If a certain change in economic organization or policy, according to Kaldor, makes some people better off and the others worse off, there will be a net increase in social welfare, when the gainers in welfare compensate the losers and are still better off than before.*

Assumptions:-

1. An individual himself is the best judge of his satisfaction which is independent of the satisfaction of others.
2. There is constancy of the tastes of the individuals.
3. There can be ordinal measurement of utility.
4. The inter-personal comparisons of utilities are not possible.
5. There is an absence of externalities in production and consumption.

Suppose there are two economic situation A and B. The former is socially preferable to B, in case those who gain from A can compensate the losers i.e. they can bribe the losers to accept the situation A and can still be better off than in situation B. For instance, the chemical factory in an area causes suffering to the people in its vicinity but the factory management compensates them and still the total product obtained by the society is more than what it would have been, had the factory been closed, there is a net increase in the welfare of the society.

J.R.hicks put forwarded his compensation criterion which is the reverse of Kaldor's criterion. According to him, if an economic change makes some people better off and the others worse off and the losers cannot bribe the gainers not to make the given change, then there is an increase in the net welfare of the society from that economic change. Suppose the government proposes to impose a tax which will benefit some and harm others. If the latter fail to bribe the government officials not to introduce the proposed tax, then the given change in tax policy will result in a net increase in the welfare of the society. *The compensation principle suggested by Kaldor and Hicks, even though stated in different words, actually means the same thing. The only difference is that Hicks has given his criterion from viewpoint of losers, whereas kaldor formulated his criterion from viewpoint of gainers.*



In the given figure, A's utility is measured along the horizontal scale and B's utility along the vertical scale. RS is the utility possibility curve. It indicates the different combinations of the utilities obtained by A and B. The movement downwards along the curve RS shows an increase in the utility of A and a fall in the utility of B. On the opposite, an upward movement along RS curve shows a fall in the utility of A and a rise in utility of B. these movements along the utility possibility curve may be on account of redistribution of income.

Suppose the two individuals A and B are initially at the point C inside the utility possibility curve. If some change takes place in the economic policy and A and B moves to position D from C, there is a fall in the utility of A whereas there is an increase in the utility of B. It is not possible to evaluate the movement from C to D from Paretian criterion. The points E, F and G lying upon EF segment of the utility possibility curve RS are socially preferable to the point C on the basis of Paretian criterion as at least one individual becomes better off while none is worse off at the points E,F and G. As there is movement from C to D, it has to be seen if the individual B (the gainer) can compensate the individual A (the loser) and still be better off than C.

According to Kaldor-Hicks criterion, as B compensates A, the income redistribution causes the movement from D to E where A's utility remains as before but B is still better off. It signifies that there is a net increase in the welfare of the society just by the redistribution of income. Even the movement from D to G will result in a net increase in social welfare because at G both A and B are better off than at the original position C. According to Kaldor-Hicks criterion, it is not necessary to pay compensation actually to judge whether the social welfare has increased or not. Only requirement is that the gainer should be potentially able to compensate the loser for the loss in his welfare and still be better off.

Criticism:-

1. This criterion implicitly assumes that marginal utility of money is the same for all the individuals in the society.
2. It suggested potential compensation rather than actual compensation. In case the potential compensation is not paid, the welfare would be measured only in terms of utility and that would require the inter personal comparisons of utility and value judgements.
3. It evaluates the gains and losses due to an economic change in money terms. The real value of gains and losses have been overlooked.
4. It ignores the existing distribution of income of the community. If the income distribution is unequal, the compensation by the gainers (the rich) paid out to losers (the poor) will fail to offset the loss on account of the differences in the marginal utility of money in case of the rich and the poor.

Thank You