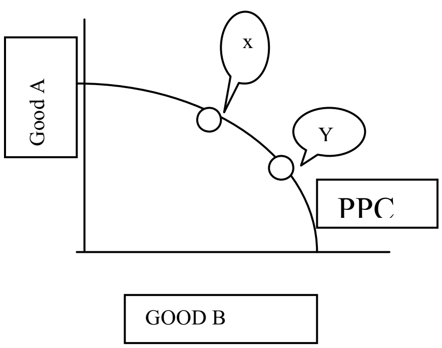
Q. In 2001 in the UK a widespread disease among cattle and sheep closed off large parts of the countryside. The government decided to give aid to agriculture but not to tourism, both of which were badly affected. Comment on the government's actions in terms of allocative efficiency and equity.

[A Level 2003 Paper 4]

Ans. Allocative efficiency occurs when resources are allocated to maximize the net benefit attained through their use. It occurs when consumers' demands are satisfied by using the resources to produce goods and services consumers want. It involves the choice of different points on the production possibility curve which shoes the combinations of goods and services that an economy can produce using its available resources.

Once allocative efficiency and productive efficiency (where firms are producing at minimum average cost) is achieved and the two of them coincide, then Pareto optimality is achieved. Pareto optimality means that it is impossible to produce more of one type of good or service without reducing the production of another i.e. one person cannot be made better-off without making someone else worse-off.



The diagram shows the country's production possibility curve (PPC) that shows all the combinations of Good A and Good B that may be produced using the existing scarce resources. Both points X and Y can show allocative efficiency because these bundle sets are desired by the consumers and reallocation of resources is impossible in a way to make one group better-off without making another party worse-off i.e. Pareto optimality.

In 2001 in UK both the agricultural and tourism sector were in crisis. The government would be able to help the agricultural sector by providing financial aid in the form of subsidies, grants and easy loans. The government may choose to do so because farmers are politically powerful and the food industry largely affects the people in the country as food is a basic necessity.

UK is a developed nation and hence it is likely that its primary sector is a small part of its total production. Therefore the government would find it necessary to help this industry survive and satisfy food demands by domestic production as far as possible rather than become dependant on imports.

By providing subsidies and grants or even ease of loans with low interest rates will enable farmers to begin production of their livestock. This is because with the financial aid the farmers can afford to buy healthy animals as well cover the cost of vaccination (if discovered) to help their animals survive. As a result the farmers can increase production at low costs and sell to the market at reasonable prices and hence earn revenue.

Due to increased revenue, profits may increase. Encouraged, farmers may hire more labour or other factors of production such as the animals, barns to increase further production. Higher profits and more employment will enable an increase in demand for other sorts of commodities too. This demand would cause rise in sales and hence firms will be encouraged to increase their output and in the process hire workers. Therefore via the multiplier the country's output, employment and income would rise.

Since food is a basic necessity it obviously increases consumers' satisfaction. Since livestock products will increase consumers' satisfaction and resources are being allocated there , the government may be targeting to achieve allocative efficiency in this way.

However, subsidies and other financial aid means those farmers will not be motivated to increase efficiency and produce at the lowest possible average cost. Hence productive inefficiency may arise. In effect, net economic welfare will be reduced and if the productive inefficiency is not offset by allocative efficiency, Pareto optimality will not be achieved.

One of the indirect factors of decline in tourism industry is the disease of the cattle and sheep. Governments' direct aid will not benefit the tourism industry if the problem of the livestock industry persists. Therefore the government might have planned on pursuing to cure the root cause rather than attempt to revive the tourism industry.

Being a developed nation, UK is likely to have a large services sector. Also having lots of historical sites and rare arts, it is culturally famous and this makes UK a potential tourist destination. And this also implies that the tourism industry can revive itself through advertising unlike the agricultural sector.

Equity is the notion of fairness and is of two types, horizontal equity and vertical equity. Horizontal equity is the identical treatment of identical individuals in identical situations. Vertical equity is the different treatment of people with different characteristics in order to promote greater equity.

In this case, horizontal inequity exists in the sense that despite both industries being affected by similar cause, the disease of livestock, the government has decided to help the farmers. However, vertical equity exists in the sense that the government has decided to help the farmers, who cannot revive their production by advertising; instead of the tourism industry that possess different qualities, elasticity of demand and can revive themselves by advertising or by offering special packages at low rates.

The governments desire to achieve efficiency can clash with the desire to achieve equity. Government intervention in markets leads to market distortion. The theory of second best suggests that efficiency will be the greatest if the distortion is spread thinly across many markets rather than concentrate on a few markets. However, the UK government is practicing an extreme by aiding agricultural sector only. Therefore, there is a possibility of allocative inefficiencies to occur.

From a normative perspective, it would rather seem ‘fair’ to aid agricultural sector because this sector produces goods which involve productivity and must be of good quality. And farmers will only be able to produce quality livestock products if aid is provided and especially because the economy is hit with a crisis. Therefore with low demand for livestock product the farmers would not be able to recover if this sector is left to free market forces alone. But the tourism sector can be left to free market forces following an appealing advertising campaign.

From the taxpayers’ viewpoint, equality is further questioned because subsidies from the government are financed from taxes. There are conflicts on how revenue from taxation must be used. The scheme of financing through taxation means that money is taken from the working population and is being distributed to a declining and currently a productively inefficient agricultural industry.

Therefore it is not possible for the government to maintain equality as well as allocative efficiency. Both aspects contain an element of value judgments and the optimal level of the economy is difficult to locate and judge. Moreover, since the production possibility frontier contains different points showing allocative efficiency, it is difficult to conclude which point provides greater equity.