

ECONOMIC BRIEF NO. 27

Using the Compensation Principle

This series of economic briefs explores fundamental concepts in economics and community and economic development.

For more than a century economists have wrestled with the problem of measuring the gains and losses when policy decisions are made which create change. And what about compensation for losses created by change?

The only rule that is universally accepted among economists is one called Pareto optimality. Under this rule no policy change should be made unless the change makes at least one person

the one in such a case? And if they can't, does it mean that it is never possible to justify making any changes?

In response to this dilemma, economists have developed a less rigid rule called the compensation principle. Under this principle, a change can be justified if the gains to those who benefit are large enough to compensate the losers for their losses and still have something left over.

What if a new highway brings benefits of \$10 million to commuters, retailers, and others and losses of \$3 million to people along the old highway? Under the compensation principle, it would

Also, this principle only requires that compensation be possible, not actually paid. Payment depends on who gains and loses. Are the gainers poor and the losers rich or vice versa? Are the gainers children and the losers adults? Are the gainers persons discriminated against in the past? Payment also may depend on political considerations.

In the 1960s, legislation which passed the gain and loss test of the compensation principle provided for major expansion in international trade to increase foreign competition but created job losses at home. Because organized labor's political support was essential for passage, trade adjustment provisions had to be added to provide compensation to affected firms and dislocated workers.

In spite of its shortcomings, the compensation principle offers a useful shortcut guide to making certain public sector decisions when there are clearly identifiable winners and losers. Next time your local government proposes a new service or a zoning change, the compensation principle could give you a whole new perspective on how to walk yourself through the difficult process of making public sector decisions.

Change can be justified if gains are large enough to produce a substantial gain after the losers are compensated for their losses.

better off and no one worse off. But it is almost impossible to make any kind of change without making someone at least slightly worse off.

What if a change made 1,000 people better off and one worse off? There is no easy answer. If 1,000 people are benefited by mildly inconveniencing one person, a change is probably justified. But what if the person dies, is severely injured, or is exposed to dangerous chemicals? Can citizens or elected officials weigh 1,000 against

be possible to collect enough from the winners through taxes, tolls, impact fees, or other means to compensate losers and still leave winners with \$7 million in benefits.

This principle doesn't give all the answers. It assumes all gains and losses can be identified and measured. However, it may leave out hard-to-measure benefits and losses like the loss of wildlife habitats, the attractiveness of a town square, the ease of getting around on good highways or public transportation.

In furtherance of Clemson University's land-grant mission, the Community & Economic Development Program at Clemson provides access for community leaders in South Carolina to expertise in all branches of knowledge on the University campus.