Chapter 2
The Compensation Principle

Extension of Pareto’s conditions was attempted when N. Kaldor [1939] discussed a change which improved the welfare of some members of the community only at the cost of others. Here was a situation in which Pareto’s principles could not help directly, since if any suffer from a change, welfare comparisons can be made only by involving distributional judgements which Pareto particularly avoided. Unfortunately in practice most economic decisions involve just such combinations of loss and gain; changes which incur only benefits for all members of society are usually undertaken without needing specific economic analysis. Problems arise when gain for one sector of society can be achieved only at the cost of decreased welfare for another.

Discussion about compensation centred initially on the decision to repeal the Corn Laws in the nineteenth century; this repeal did not improve welfare in the Paretian sense since although large numbers benefited by having cheaper bread some farmers were worse off because the price of corn had been lowered. Kaldor maintained that if those who benefited from the repeal were so much better off that they could have afforded to compensate the farmers for their loss, and yet still be in a better position than before the change in the law, then the repeal of the Corn Laws represented an increase in welfare for the country as a whole, even if the compensation was not actually handed over.
If full compensation is paid then no controversy arises, since the 'losers' are compensated and so the conditions for a Paretian improvement are directly satisfied, with some gaining and none losing. However, for a situation in which the gainers could compensate the losers, but do not do so, welfare judgements involve assumptions far beyond those which Pareto himself was prepared to undertake. These arise in two ways. First, the compensation which a loser requires or a gainer is prepared to sacrifice so that he feels himself just as well off as before the change depends on his total level of well-being, that is on the distribution of income. (Since we assume that the marginal utility of money decreases, an individual measures his loss of utility as greater in money terms if he has a higher level of income.) Thus in accepting these personal assessments of changes in utility in money terms (and it is difficult to know how else to measure them) the economist accepts that the distribution of income is satisfactory. Consider, for example, a new road which affects two houses by a compulsory-purchase order on part of their gardens. Suppose that the inconvenience is judged to be similar by each family, that they are similarly placed in terms of family circumstances and that it affects equally the value of their properties. The poorer family may be prepared to settle for a lower compensation, even though their loss of utility seems equal to that of their rich neighbours, because the utility of the money they receive is greater and their lives might be made easier by increased expenditure on food, clothes or household equipment. Their richer neighbours may already have such items and therefore require more money to buy goods giving them equal utility to that lost by the road scheme. (Some of the practical problems of assessing the effect of development schemes on residential housing are discussed in Chapter 12 on the siting of the third London airport.) Clearly using monetary compensation as a measure of utility loss or gain implies acceptance of the current distribution of income.

Since in practice the welfare economist has to make some assumptions about the economic system (as we shall see in later chapters), supposing that the distribution of income is reasonable, or at least that the Government is fairly satisfied with the status quo, may not seem outrageous. More important is the second implicit assumption in Kaldor's compensation principle, that the redistribution of income from losers to gainers which results from the change is also satisfactory. Kaldor suggested that when the Corn Laws were repealed only the total change in utility was relevant even though it involved a redistribution of welfare from growers of corn to consumers of bread.