Critical Analysis of Kaldor-Hicks Efficiency Criterion, with Respect to Moral Values, Social Policy Making and Incoherence

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ABSTRACT

The concept of efficiency has great importance in the literature of law and economics. Amongst different efficiency criterions, Kaldor-Hicks Efficiency Criterion has received several positive and negative comments. A fundamental issue in economic analysis of law is to change laws for obtaining more efficient laws. Kaldor-Hicks criterion claims that in certain circumstances, it is possible to change available rules for obtaining more economic benefit and efficiency, while this change may create loss to some specific groups. This question has specific practical importance; since, legal and social decisions should be made according to advantages and disadvantages and their impact on different classes of society. In fact, those suggesting this criterion have offered a rule for making collective decisions that are not applicable by Pareto criterion. In this regard, Kaldor-Hicks criterion is observed as basis for making social decisions and changing laws. However, applying this criterion has other consequences as well that attracts critical attentions. The present article attempts to evaluate these critiques with respect to technical issues and incoherence, moral principles, political decision making and social justice.

Key words: Economic analysis of law, efficiency, Kaldor-Hicks criterion, legal system, wealth maximization

Introduction

In law and economics literature one of the most important criterions of economic efficiency is Kaldor-Hicks criterion. Based on this criterion that is famous for two English economists named Nicholas Kaldor and John R. Hicks, Policy 2 (e.g., restricting pollution) is preferred to policy 1 (e.g., not restricting pollution) if those who gain from policy 2 could hypothetically compensate those who lose in going from policy 1 to 2 so that everyone would be made (weakly) better off by moving from policy 1 to policy 2 [1]. In the field of contract and transaction, economic efficiency is obtained when performing a transaction results in improving status of one party, even if the other party face with loss, conditioned that the first one would be able to compensate the loss i.e. higher profit of one party means to compensate loss of other party. Of course compensating loss is a hypothetical assumption and is not necessary to happen in reality. Therefore, Kaldor-Hicks efficiency criterion is more real than Pareto criterion and is more acceptable in economic analysis of law. Thus, Posner believes that his criterion i.e. wealth maximization and Kaldor-Hicks efficiency criterion are equal, so it will result in wealth maximization.[2]

Kaldor-Hicks efficiency criterion was created for overcoming difficulties of Pareto criterion; since, Pareto criterion, in spite of being exact and satisfactory for both parties, is not possible to apply for social problems and making legal decisions because it is not possible to expect no group or person would face with loss, as consequences of different social decisions. The problem is obtaining a mechanism for reaching maximum social satisfaction.

Kaldor-Hicks efficiency criterion is created for solving this problem and offers clear answer to this question. There are several criticisms toward Kaldor-Hicks efficiency criterion. These criticisms were generally offered by economists, legal scholars, and founders of law and economics, with respect to technical, political and moral aspects. Critics of Kaldor-Hicks efficiency criterion have offered their criticisms in relation to negligence of this criterion about distributive justice, neglecting moral values, problem of measuring benefit, and not compensating persons facing with loss. Other disadvantages of Kaldor-Hicks efficiency criterion are neglecting individual will, lack of guarantee for increasing utility of society and logical paradox of Kaldor-Hicks efficiency criterion.

1) Logical Paradox:
In 1941, Tibor Scitovsky referred to logical paradox of Kaldor-Hicks efficiency criterion for the first time. Scitovsky stated that this criterion is ambiguous, and potentially paradoxical i.e. movement from social status A to social status B has Kaldor-Hicks efficiency, sometimes movement in opposite direction i.e. from social status B to social status A also, results in Kaldor-Hicks efficiency [3].

For example, assume an economy that is formed from A and B persons and X and Y products and preferences of A and B are as follows: person A prefers a unit of X product and a unit of Y product over 2 units of X products and prefers 2 units of X over one unit of X, and person B prefers a unit of Y and a unit of x product over 2 units of Y products and prefers 2 units of Y product over a unit of Y product. Summary of these preferences are offered in table 1:

Table 1:

<table>
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<tr>
<th>Ranking</th>
<th>Person A</th>
<th>Product x</th>
<th>Product y</th>
<th>Person B</th>
<th>Product x</th>
<th>Product y</th>
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Now assume 2 social statuses I and II. Table 2 show X and Y products for person A and B. In social status I there are 2 units of product X and person B has a unit of product Y. Social status I is not most suitable status for person A; since, he prefers to have a unit of each product; nevertheless, social status II is more suitable and person B selects social status I. Therefore, social status II is more suitable for person B.

Carefully looking at this table, we find out that according to Kaldor-Hicks efficiency criterion, social status I in comparison to social status II has higher efficiency; meanwhile, social status II in comparison to social status I is also efficient. Under status I if person A gives a unit of X to person B and he himself has a unit of X, his utility is similar to social status II but under such mode the status of B has improved by having one unit of each product. Person B has more utility now, while the opposite of this is also true.[4]

As it is observed, Scitovsky has proved that Kaldor-Hicks efficiency criterion is unable to determine economic efficiency of legal changes (preferring social status I to social status II and vice versa) and may results in logical cycle between status I and II. under such mode it is preferred to keep current status; since when there is ambiguity for executing a decision, it is impossible to decide based on Kaldor-Hicks efficiency criterion and to prefer the second mode to first one. [5]

Scitovsky has suggested that in order to solve this problem it is required to evaluate a change with respect to two aspects, to determine its compatibility with Kaldor-Hicks efficiency criterion. In order to do so, a change or decision while having Kaldor-Hicks efficiency, its opposite mode should not have Kaldor-Hicks efficiency. Accordingly, his suggestion was called double Kaldor-Hicks test or Scitovsky test.

Existence of paradox does not void Kaldor-Hicks efficiency criterion; since, by completing it as suggested by Scitovskky this problem would be solved [6]. Generally, this paradox is visible more clearly in macro governmental projects, which result in great change of price, and in small projects that do not have tangible effect on price, probability of raising this paradox is very few. What Scitovsky mentioned about this criterion is more important with respect to theoretical and technical aspect instead of make it insufficient and unpractical [7].

2) Measurement Problem (Calculation):

Kaldor-Hicks efficiency criterion implies that beneficiaries of a decision should hypothetically be able to compensate losses of losers. Measurement unit to compensate potential loss is not utility; rather it is money. According to Kaldor-Hicks efficiency criterion, and in spite of Utilitarianism, social utility is not maximized; but the wealth would be maximized. The criterion for assessing this increase of wealth is hypothetical willing of persons to pay money in return of a specific product or resource [6].

Kaldor-Hicks efficiency criterion claims that it is better to replace willingness to pay with utility. Therefore, utility is replaced by money unit and by measuring hypothetical willingness to pay, besides overcoming the interpersonal comparison of utility problem, it is possible to perform objective comparison and allocate rights based on result of this comparison. And claims that it is possible to determine hypothetical willingness of people to pay,
through the mechanism of appearing prices i.e. 
market.

But the critics assert that our knowledge about 
price in market goes back to past and only refers to a 
reality of economic history. Past prices only referred 
to preference of purchaser to pay for transaction on 
that moment and nothing more. Only a few minutes 
after transaction, purchaser is not willing to pay the 
same price. Market is always changing and prices are 
not fixed; therefore, it is not possible to decide the 
present time according to decision of person in past. 
Price refers to agreement in past; however, Kaldor-
Hicks efficiency criterion demands us to assume 
imaginary situation that is not happened and based 
on past prices, to determine the present preferences 
of people [7].

Regardless of aforesaid disadvantage, the 
question is that how the courts would be able to 
determine loss of losers and benefit of gainers in a 
trial. Richard A. Posner, the famous American judge 
and law scholar in his book “Economic Analysis of 
Law” restructured Kaldor-Hicks efficiency criterion, 
under the title of Auction Rule. This rule attempts to 
reformulate function of market through auction in 
non market behaviors and allocate rights according to 
auction rule to the highest bidder i.e. the person who 
is mostly willing to have it and is ready to pay for. 
For example according to auction rule the right of 
constructing a factory near to residential area or the 
right to stop this decision shall be allocated to person 
having the highest tendency and is ready to pay the 
highest price in return of obtaining it. Each person 
prefers, hypothetically, to pay the highest price, shall 
obtain the related right [8].

According to auction rule, the parties who are 
interested in a subject are the persons who decide 
how much of money for allocating this right would 
be paid. Through their preference to pay they decide 
value of moving from one social status to another 
or vice versa, i.e. how much they are ready to 
pay to prevent from such change. The problem is that 
how a judge may be aware of preference of people 
and the value they give to a subject without any 
transaction actually made. When there is no 
transaction. Using assumed selection and making 
judgment in relation to value, regardless of its result, 
indicates selection of judge, not willingness of 
people to pay [7].

It seems that new structure of Posner is not 
possible to solve problem of evaluating loss within 
Kaldor-Hicks efficiency criterion; since, assumed 
willingness of people to pay money is accompanied 
with information problem and do not help judge to 
make decision. Therefore, discussions of Posner in 
relation to assumed market and assumed preference 
has gone under many criticisms. Generally it is 
impossible to obtain enough information about each 
person in society.[8]

In fact auction rule by basis of assumed 
preference is rarely applicable; since, according to 
strategic behavior parties interested in a subject may 
prefer to pay more amount of money in comparison 
to time that they really intend to pay money. Auction 
rule at its best condition is a tool for benefit-cost 
analysis that assists judge to estimate benefit and loss of 
each party. Jules Coleman that has offered a 
complete critical analysis in relation to auction rule 
and has studied its logical and moral consequences 
believes that auction idea for following up market is 
completely useless. If there is market, there is no 
need to auction rule and if real market is not existed, 
the auction rule is ineffective[9]

3) Not Compensating Losses:

Assumption of hypothetical compensation at 
Kaldor-Hicks efficiency criterion is distinguishing 
point with Pareto criterion. Based on Pareto criterion 
a status has efficiency if no party is worse off than 
before (and at least the status of one party is 
improved) i.e. it does not remain non-compensated 
loss [10]. But, in Kaldor-Hicks efficiency criterion, it 
is not required to compensate actual loss, and when 
benefits of a decision or change is higher than its 
loss, the Kaldor-Hicks efficiency criterion is 
obtained and such decision or change has Kaldor-
Hicks efficiency.[11]

Kaldor believed that “ability” of compensating 
loss is an objective criterion of increasing welfare. He 
believed that ability of compensating loss whether 
actual compensation is made or not, is 
enough for utility of a decision. Kaldor added that 
economics is only in search of increasing wealth, and 
deciding to compensate loss or not is beyond the 
field of economics.[12] Economists are not able to 
solve the problem of suitable distribution of income 
from economics point of view; since, he believes that 
compensating loss is a political issue. Hicks approves 
view point of Kaldor and knows the ability of 
compensating loss as an objective criterion that 
through its application, it is possible to make clear 
decisions in relation to level of welfare in society. 
Hicks believes that actual compensation is a matter 
of policy of wealth distribution, that in spite of 
economics that its principles are universally valid, it 
is not possible to allege universal validity for it. It 
seems that offering response for how to distribute 
wealth is irrelevant to efficiency.[5]

The origin of this issue was that Kaldor and 
Hicks have established their criterion of efficiency 
based on Corn Laws in England that removed legal 
protections of corn farming. According to this 
approach, any benefit obtained from protections of 
government is illegitimate and in case of losing, it is 
not required to compensate their loss. Therefore there 
is no reason to compensate farmers facing with loss 
as a result of revision at Corn Law, just the same as 
oppositions of slavery who believed that by 
revocation of slavery, there is no other reason to 
compensate loss of persons involving at slavery.[13]
Kaldor-Hicks efficiency criterion completely rejects necessity of actual compensation. Benefits and loss are allocated based on willingness of parties to pay. Meanwhile, “willingness” to pay is not only depending on utility of that resource for person, but also depends on “ability” of that person to pay money. Whereas poor people have less ability of paying in comparison to wealthy people, their willingness to pay will be less than wealthy people. By this analysis and according to Kaldor-Hicks efficiency criterion, share of poor people is very trivial and most resources are allocated to wealthy people. As a result of continuing this process in free market, gradually all resources are allocated to wealthy people without paying real amount of money. Poor people even in case of having enough willingness to pay, due to not being able to afford costs, will receive nothing and this gap is gradually increasing. Some critics believe that this is the most important problem of this criterion.[14] This problem has resulted in another criticism to this criterion i.e. negligence to distribution of income. In addition, some people have criticized that there is no guarantee for increasing utility of society.

4) Collectivism:

Cento Veljanovsky in his famous article “Wealth Maximization, Law and Ethics on Limits of Economic Efficiency” that was published in year 1981 criticized principles of wealth maximization of Richard Posner. In his article he analyzed pre-assumptions and effects of applying Kaldor-Hicks efficiency criterion and also wealth maximization and criticized them on morals and philosophical basis. Veljanovsky asserted that on the contrary of Pareto criterion that free will of person is completely effective on going to new status, people’s will in Kaldor-Hicks efficiency criterion is ineffective.[15]

Kaldor-Hicks efficiency criterion, through measuring money that people are ready to pay, prevent from inter personal comparison of utility. On this basis, the most important thing is total utility of society and personal values may not create change. Critics say that here, money unit is just replaced by utility and on this basis has no difference with Utilitarianism. George Fletcher believes that the only difference between Utilitarianism and followers of Kaldor-Hicks efficiency criterion is that the first, is based on enjoy and the second is based on assumed willingness to pay in return of allocating a resource.[13]

In addition, trivial amendment in Pareto principle for being changed to Kaldor-Hicks efficiency criterion, philosophically, creates significant difference as follows: Pareto principle respects personal will; since, on this basis person is free to decide which contract to enter; therefore, his rights are not violated without his consent. On the other hand, Kaldor-Hicks efficiency criterion is based on this idea that people’s rights, in case of increasing economic efficiency, may be violated. A principle that prefers priority of man is changed to a principle that prefers priority of economic efficiency. In fact individualism is replaced by collectivism.[6]

5) Lack of Guarantee to Increase Utility of Society:

Other criticism to Kaldor-Hicks efficiency criterion is that it does not increase utility of society.[16] Assume that making a decision adds $10 to property of a wealthy man and decreases $9 from property of a poor man. Under this case the wealthy man is able to completely compensate loss of poor man and he is still benefiting as well. With respect to Kaldor-Hicks efficiency criterion, this status is regarded as efficient status. But how is the status of these two persons with respect to utility? In case of not compensating loss and assuming marginal decreasing utility of each unit of money by increasing income, the lost utility of poor person is higher than utility of wealthy person and therefore social utility is decreased (Mathis, 2009). Another example: assume a wealthy person that is involved at economic activity and noise of his activity is bothersome for his poor neighbor. Whereas poor neighbor has less financial power, he may less evaluate the value of decreasing noise and therefore there is no way to oblige wealthy neighbor to use technology for decreasing sound noise. This example deals with wealth maximization principle of Posner that would result in wealth increasing in society; however, it is not possible to conclude an increasing of utility in society.

Kaldor-Hicks efficiency criterion is based on cost-benefit analyzing and is regarded as the most common method in economic analysis. Whereas there is no complete tool for evaluating personal utility, analyses based on this criterion have considerable technical difficulties. Kaldor confirmed that economists are not able to establish policies that result in comparing utility between different people; however, he insisted that such concern is not needed. he argued that policies that result in general increase of net income are always regarded desirable; since, they may potentially improve status of people[17].

However, some scholars believe that new welfare economics is involved with value judgment and it is impossible to prevent it.[5] Generally, it is accepted that there is not non-value recommendation i.e. proving that a social status is better or worse than other status is regarded as implied value judgment.[8] The most important issue is that a judgment would be according to clear basis to find out its consequences; therefore, in order to select an economic policy, the most important thing is not preventing value judgments, rather other basis are more important.[5]

Within Kaldor-Hicks efficiency criterion, personal selection and freedom is neglected for
increasing economic efficiency and total utility of society i.e. increasing efficiency and wealth result in utility of society as basis for general policy making. Now this question is raised that, whether money unit is regarded as suitable objective criterion for society or not? Examples mentioned in the beginning of this section show that Kaldor-Hicks efficiency criterion, contrary to Pareto criterion may not guarantee increasing utility of society. Another basis for selecting public policy is public consensus that is observed at Pareto criterion of efficiency and its background goes back to many years before offering Pareto criterion. Social contract theory of Rousseau is based on public agreement [18]. Jurgen Habermas has offered his theory based on the same principle and believes that through process of ideal discourse it is possible to obtain public consensus [8].

6) Unanimity:

As we already know the privilege for criterion of Pareto is that it is based on mutual consent; since it does not allow one party to be worse off. The distinguishing point of Kaldor-Hicks efficiency criterion is that it is not limited to not aggravating status of one party. This question is raised that by assuming not to compensate loss, how it is possible to reach consensus in relation to this criterion i.e. when the status of a person is worse off, will he agree with such a plan that does not actually compensate his loss? Is it possible, According to this criterion, to access social contract and consensus?

It may be said that if Kaldor-Hicks efficiency criterion is applied for all legal rules, it is expected that each person during different time of his life is among winners or losers; accordingly it is possible to obtain a basis for consensus. Although each item of loss is not compensated separately, upon passing time, a type of general compensation is performed that results in distributing welfare effects of each decision and gradually optimal status of Pareto would be created. Therefore, consensus in relation to Kaldor-Hicks efficiency criterion is obtained through general compensation.[8] On this basis it is possible to say that ability of benefiting higher economic growth during time results in specific cases of compensating loss. Although this inference in first look seems to be valid, there are some complains to it as follows:

1) Scale of some loss may be so great that general compensation is not enough. For example if a great number of people due to an action face with poverty and famine, theoretical perspective for participating at higher economic growth may not result in comfort for them

2) John Maynard Keynes in relation to long term compensation has mentioned that: In the long run, we are all dead. [6] Anyway, ordinary people evaluate certain and immediate loss more severe than potential future benefits. In addition, even within long term there are some people having very low chance to compensate loss.

3) The most important thing is that human need to be treated justly, in an inclusive and one by one manner, not partially and by discrimination. The vague perspective of general compensation does not give a good reason for accepting a specified unjust decision. The concept of justice, however is defined, has a fundamental value in mind of people and it is difficult to compare it with an improve in economic efficiency. Feelings of people is originated from their personal experiences, not abstract concepts including mechanisms of general compensation.[15]

Horset Eidenmuller, German scholar, believes that persons facing with loss would be content with a change in their situation when they are sure that their loss will be certainty compensated. He rejects general compensation idea and asserts that it is not reasonable to expect people to wait for benefitting from long term effects of general compensation. This criticism seems true since, firstly, change in legal system has asymmetrical effects; secondly, success of Kaldor-Hicks efficiency criterion depends on general compensation which is based on unreal assumption.[8]

Negligence of Kaldor-Hicks efficiency criterion to income distribution and also compensation loss, is in paradox with public belief and empirical instances showing that considerations related to redistribution of wealth and income as a result of public policy may have more importance.[15] Policy that is negligent toward income distribution and do not attempt to compensate loss, is not suitable for consensus. Therefore it does not seem that Kaldor-Hicks efficiency criterion be able to provide a basis for unanimity.

7) Negligence to Income Distribution (Distributive Justice):

Another criticism to all law and economic attitudes is negligence to wealth distribution. Mere attention to the total wealth of society as goal of law and economics, has resulted in negligence to proper wealth distribution. Meanwhile, any legal rule is influential in method of wealth distribution and law shall be formed in accordance with distributive consequences.[19]

This criticism include Kaldor-Hicks efficiency criterion and wealth maximization principle of Richard Posner and in fact is more serious about these theories; since, market demand and willingness to pay are limited to purchase power and level of income. In fact the greatest criticism is toward Kaldor-Hicks efficiency criterion that has neglected wealth distribution. Critics have mentioned that economic analysis neglects just distribution of income and covers concept of efficiency that concerns mostly with wealth maximization and does not deal with distributive effects.[20]
Origin of this problem is that an approach that was first of all explained by Kaldor and then Hicks approved it attempts to separate economic efficiency from income distribution in order to obtain criterion free from value judgment and based on scientific principles. Kaldor has inferred that economists may not deal with income distribution. The same as Pigou, he insisted dividing welfare matters into two groups including: production and distribution. In relation to distribution, he believes that economists should not make normative economic recommendations; since, it is impossible to determine income distribution pattern based on pure economics, and to increase social welfare. [21]

Velianovsky in the way of criticizing Kaldor-Hicks efficiency criterion has mentioned that: "...Kaldor-Hicks efficiency is not income distribution-neutral, which is to say that it gives greater priority to those with income and market power. To the extent that the existing distribution of wealth is deemed 'unjust' in society the ethical appeal of the Kaldor-Hicks test must corresponding diminish. [15] It seems that within unjust society, moral expectation about Kaldor-Hicks efficiency criterion (for creation of justice) is remained unanswered. In other words, if the present pattern of income distribution is more unjust, ability of Kaldor-Hicks efficiency criterion in wealth distribution is lower. A system that is organized accordingly, increases unjust income distribution; since, allocating rights based on willingness to pay and financial power, only let rich persons having benefit from new resources. [6]

Separation of economic efficiency and income distribution has been accepted as basis for economists. [17] In economic analysis of economic law it is referred that today's legal system has two sections: the first section that is in charge of efficiency and the second section that is in charge of social justice and capacity of civil law is more in obtaining efficiency rather than justice. [8]

Preference for establishing a new study approach based on pure scientific principles, is the principal reason of neglecting concept of justice in law and economics. Therefore, founders of law and economics approach have referred that justice is an intuitive, illogical and non-absolute concept; therefore, they neglect this issue within their researches and in contrast insist on economic efficiency as an objective goal. Within such approach a suitable legal system encourages mindfully wealth increase and neglects distribution and justice. Meanwhile, in traditional legal system the concept of justice was at the center of attention of legal system. [21]

The same approach has resulted in many criticisms in relation to outcomes of economic analysis of law. Many of these criticisms are raised based on unsuitable consequences of economic analysis of law. One of the most important criticisms is existence of a paradox between consequences of economic analysis of law and justice. [21]

8) Negligence to Moral Values:

Criticism of Kaldor-Hicks efficiency criterion to distribution of income is part of a more general criticism to this criterion i.e. neglecting moral values. Critics believe that cost-benefit analysis that today's acceptable method of executing it, is by using Kaldor-Hicks efficiency criterion, neglects ethical values including: personal integrity, fulfilling promises, commitment to moral principles. [20] For example, normative economic analysis of law rejects actions of a person that use resources to fulfill promises to his deceased friend, and infers that he would not benefit from fulfilling such promise and such fulfilling only results in wasting resources. Therefore, cost-benefit analysis, according to moral basis is incorrect and may not reject actions including: rape, slavery and abortion. [17]

Critics believe that in normative economic analysis of law, moral principles are studied incompletely; since, fortune of future generations is not paid enough attention and inter-generational justice is ignored. Cost-benefit analysis is based on utilitarianism and on this basis, pleasure gained by improper actions including sadistic ones are equal to happiness of other people for fulfilling good actions like helping each other. [5]

Posner believes that in wealth maximization system, it is expected to have slavery and torture. Being aware of such results, he does not reject them, but also defends them and believes that, if these actions are voluntarily and according to free will of person, and in the way of increasing efficiency and wealth of society; they may not be prohibited. [2]. Of course, he believes that slavery is inefficient; since cost of taking care of slaves in return of their benefit is much higher, nevertheless, this economic inefficiency based on wealth maximization principle is very different with absolute prohibition of such actions as expected from a legal system.

Critics refer that applying Kaldor-Hicks efficiency criterion results in neglecting substantial and irrefragable human rights. In fact, in addition to unknown relationship between wealth maximization and justice as goal of law and other social and political goals that law attempts to obtain, the possibility of targeting wealth as an independent value of legal system is under serious question. Wealth maximization does not seem to be an independent desirable goal; wealth does not have independent value and people through obtaining wealth, attempt to reach other suitable goals. Legal systems attempt to obtain different political, social, economic and moral goals that diminishing them in concept of economic efficiency and wealth maximization is fundamentally incorrect and unacceptable. [22]
Conclusion:

Aforesaid issues were summary of criticisms against Kaldor-Hicks efficiency criterion during recent three decades from technical, moral, political and social views. We attempted to offer most important criticisms in this article and to neglect other less important ones including (status of prior distribution of resources [23] and neglecting transaction cost [26]. Nevertheless, the greatest advantage of Kaldor-Hicks efficiency criterion is offering a clear basis for making general social decisions to terminate all ambiguities and uncertainties, and result in increasing wealth and social welfare during long term. The most important factor to apply Kaldor-Hicks efficiency criterion is the present status of income distribution, so that if the present pattern of income distribution is unjust in society, then Kaldor-Hicks efficiency criterion may have less ability to create equality in society and may deepen the existed gap.

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