Diminishing Marginal Utility and the Utility of Diminishing Marginal Inequality

by

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If you have no chairs in your house then getting a first chair will be tremendously useful to you. A second chair would also be a huge help, though the difference it makes is probably smaller than the first chair. If you got more and more chairs, the pleasure obtained from each additional one would grow smaller and smaller. If you were to receive a tenth chair, its contribution to your well-being would be minimal. This fundamental principle of modern economics, taught in Econ 101 courses throughout the land, is called the Law of Diminishing Marginal Utility. It is an intuitive concept used to explain, among other things, why a firm may need to decrease the price of their product in order to boost sales.

But economists rarely consider that this economic "law" has serious implications for evaluating inequality of income and wealth. Economics courses briefly discuss "utility" in terms of goods, then move along to discuss benefits or costs exclusively in terms of dollars. Since pleasure, like pain, is experienced subjectively, an economist would be hard pressed to say whether the marginal utility of your second chair is greater than the additional usefulness from your second lamp. But if you paid $100 for the chair and $60 forth lamp, then, any introductory economics text would declare that you must value the chair more highly than the lamp. Since the goal of economic policy should be to maximize social welfare-the utility that people in the aggregate obtain from consuming goods and services-economists use dollar values as a stand-in for utility and compare dollar amounts when making com-pari sons about well-being or the results of different policy options.

The problem is that the marginal utility of a dollar is almost certainly greater for some people than for others. An additional dollar would make a bigger difference in the life of a poor person than it would for a wealthy person. To someone with no money, a few extra dollars can mean the difference between hunger and a meal or between sleeping in the snow or renting a room. That same few extra dollars in the hands of a millionaire represents the difference between a sirloin and filet mignon. By counting well-being in the shorthand of dollars, economists conclude that nothing is gained by shifting money from a millionaire to poorer folks. Since no extra well-being or usefulness is created, redistributing income, economists say, is not "pareto optimal"; the poor are made better off, but only by making the rich worse off.

Economists recognize no difference between a situation where one million dollars is divided relatively equally among ten people and a situation where one person receives $900,000 while the remaining nine people get $11,000 each. By contrast, it seems obvious that ten chairs are much more usefully divided equally among ten people than if one person sat on nine chairs while the remaining nine people shared a single chair.

In recent decades, as inequality has increased in America, it makes less and less sense to always use dollars as a stand-in for what we really care about, actual utility or well-being. For instance, in the 1960s the average chief executive officer (CEO) heading a large corporation made about 45 times as much as their average worker. By the end of the 1990s a typical CEO made times as much as their average employee. Major corporations argue it is worth paying these astronomical salaries in order to recruit CEOs who inspire confidence among investors. The question is whether society benefits when a few corporate executives receive millions while ordinary workers see pay increases of only a few dollars. Is social well-being enhanced when the very rich can build 10,000 square foot second homes, but the typical worker gets only enough for an extra tank of gas?

Some economists counter that the rich worked hard for their wealth and enjoy their summer homes every bit as much as the rest of us would all enjoy an extra night at the movies. Others contend that inequality has its own “utility" as a spur for people to work hard and innovate. But going back to the economic principle of diminishing marginal utility reminds us that real needs and satisfactions can be most usefully met by sharing resources more equally.

Resources: Executive Excess 2000: Seventh Annual CEO Compensation Survey, Institute for P