X-inefficiency

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X-inefficiency is the difference between efficient behavior of businesses assumed or implied by economic theory and their observed behavior in practice. It occurs when technical efficiency is not being achieved due to a lack of competitive pressure. The concepts of X-inefficiency were introduced by Harvey Leibenstein.[1][2]

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Overview

Economic theory assumes that the management of firms act to maximize profit by minimizing the inputs used to produce a given level of output.

Competition energizes firms to seek productive efficiency gains and produce at lowest unit costs or risk losing sales to more efficient rivals. With market forms other than perfect competition, such as monopoly, productive inefficiency can persist, because the lack of competition makes it possible to use inefficient production techniques and still stay in business. In addition to monopoly, sociologists have identified a number of ways in which markets may be organizationally embedded, and thus may depart in behavior from economic theory.

Organizational slack occurs when firms opt to employ more resources than are needed to produce a given level of output. Unused capacity results in X-inefficiency. Organizational slack can be explained by the agent-principal problem. In companies ownership and management are separate. Shareholders (the principal) elect directors (the agent) to act on their behalf and maximize shareholder value. Managers may take decisions that maximize their own and not shareholder objectives e.g. hiring extra staff to reduce manager workloads. This increases unit costs.

X-inefficiency only looks at the outputs that are produced with given inputs. It doesn't take account of whether the inputs are the best ones to be using, or whether the outputs are the best ones to be producing. For example, a firm that employs brain surgeons to dig ditches might still be X-efficient, even though reallocating the brain surgeons to curing the sick would be more efficient for society overall. In this sense, X-inefficiency focuses on productive efficiency and minimising costs rather than allocative efficiency and maximising welfare.

Examples

Monopoly

A monopoly is a price maker in that its choice of output level affects the price paid by consumers. Consequently, a monopoly tends to price at a point where price is greater than long-run average costs. X-inefficiency, however tends to increase average costs causing further divergence from the economically efficient outcome. The sources of X-inefficiency have been ascribed to things such as overinvestment and empire building by managers, lack of motivation stemming from a lack of competition, and pressure by labor unions to pay above-market wages.

See also

- Inefficiency
- Government failure
- Government waste
- Pareto efficiency
- Production, costs, and pricing

References

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