Pigovian Welfare Economics

The presence of external effects in production was seen by Prof. Pigou in the divergence between social net product and private net product. He defined social net product “as the aggregate contribution made to the national dividend” and the private net product as the contribution which is capable of being sold and the proceeds added to the earnings of the person responsible for investment.

The divergence between the two products shows itself in the form of external effects of production associated with marginal increments of output. In some cases social net product is more than the private product while in others private product is greater than the social product. As an example of the former, Pigou pointed out to the greater social benefit from technical training of workers by a private firm.

As an illustration of the latter he cited the fact that the smoke rising from the chimneys of private factory spoils the atmosphere of the locality and increases the laundry bills of the people of the neighbourhood. But people are not compensated in any way by the factory owner.

He was of the opinion that the state should equalize the private net product with social net product, if in an industry where private net product is more, it should be taxed, and if another industry shows a lesser private net product, it ought to be subsidized. Of course, Prof. Pigou recognised that the divergence between private net product and social net product cannot always be quantified and measured in terms of money.

Prof. Pigou made the first attempt to lay down the conditions of social optimum which he termed "the ideal output" of the economic system as a whole. In his view, the social optimum prevails when marginal social products are equal in all industries and thus production of real wealth is maximised.