

The Most Efficient Holiday Gift of All

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I often tell my students never to speak of “efficiency” in polite company. Economists don't use the word the same way as other people, and it's neither easy nor pleasant to explain at a dinner party.

Efficiency permeates most economists' thinking. Seeing how the concept relates to Christmas and gift-giving can tell you a lot – both about what economic efficiency means and also about how economists differ from normal people.

Markets provide an institutional setting in which producers take relatively low-value resources and convert them into goods and services that consumers value more highly. In a well-functioning market, producers receive more than they need to cover their costs and consumers pay less than the highest price they are prepared to pay. Economists call these differences “economic surplus”, and markets are said to be efficient when they produce lots of it.

Money enters the picture too. In a world without money, market transactions would exist but they would be much more cumbersome because of the need to barter goods and services for each other. Money is a crucial invention because it is a “generalized medium of exchange” that allows us to avoid the difficulties of barter. By using money, we have more transactions and more surplus, and so we have more efficient markets.

There are many examples of inefficient markets – situations in which the transactions don't produce as much surplus as possible. Tariffs, subsidies, output quotas and regulated price controls are all situations that typically produce inefficiencies.

The giving of gifts can also create inefficiency. Suppose I purchase a \$100 sweater and give it to my daughter for Christmas; but she doesn't like it and values it far below \$100. In this “transaction”, surplus has actually been destroyed, not created. The main problem is that givers often don't know what the recipient really wants. If we do know, then gift giving might be reasonably efficient. But if we err in judging their preferences, as we so often do, then the whole process can actually be very inefficient and destroy a lot of surplus.

This inefficiency of gift-giving is only made worse when you consider the valuable time and effort that is spent in the process – both in selecting the gift and then in returning or exchanging an unwanted gift.

But efficient gift-giving is certainly possible. If I instead give my daughter \$100 in cash, there is a pure transfer of purchasing power, and no surplus is destroyed in the process. Even

better, neither she nor I waste any time selecting or returning the gift. Cash is the perfectly efficient gift.

Some might accept this logic but think the overall loss is very small. In a paper published in the 1993 *American Economic Review*, however, economist Joel Waldfogel estimated that, on average, the process of gift-giving destroyed between one-tenth and one-third of the purchase price of the gift. Think of the billions of dollars that will be spent on gifts this Christmas and then take, say, 25 percent of that number. That's a large loss of economic surplus.

I can think of only one reason why this loss might now be smaller than back in 1993. In the past decade or so, we have seen the rise of gift cards that you can purchase from Starbucks or Canadian Tire or Chapters or hundreds of other retail outlets. By giving these pre-paid cards, the chances of the gift being surplus-destroying are much reduced. You may not know which book I want, but if you know that I like to read you can be sure I will find something I truly want at Chapters. Gift cards make gift-giving more efficient because they are more ... well ... more like cash.

Given the large inefficiency associated with giving Christmas gifts, why do we continue to do it? Here is where you *don't* need an economist for the right answer. We give gifts because it gives us pleasure to do nice things for people we care about, and recipients are touched to know others are thinking of them. Efficiency isn't the only thing that matters.

But today is December 24, and you likely have some Christmas shopping yet to do. If you don't really care about efficiency, then just do your usual thing and don't look back. But if efficiency strikes you as a worthwhile objective, you now know what to do. Nothing says "I love you" as efficiently as one of those brand new polymer \$100 bills.

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