Chapter Twenty: Welfare Economics
(pg 397 - 425)

Background

All early economists thought they were "welfare" economists

Of course they were concerned by society's wealth

Political economy was a branch of Philosophy; i.e. morality

By 1900, the split between Positive and Normative Econ was real

Recap – positive science vs. normative "science"

Starting about 1900, the science of economics began looking at norms

How should society/individuals allocate goods….

Vilfredo Pareto

Italian (1848 – 1923), born in Paris, school in Turin, prof. in Switzerland

Had made his name by refining and improving Edgeworth's indif. Curves

(make joke about how I didn't quite get to this part)

More importantly, Pareto Optimality

When is trade/exchange welfare improving?

Wanted to get away from Walras's "general equilibrium"

To much focus on production, not trade

No utils

Pareto optimal: no unexploited opportunities to trade

Optimal distribution of goods: when MRS for two individuals is the same. If it isn't, then by moving a good from to the other, utility can be increased

Optimal technical allocation of resources: when the Marginal rate of technical substation for two factors of production are equal. Otherwise, we could be producing more with the same value of resources, by rearranging our input units. Eventually, you can't get any more production (diminishing returns to scale for each)

Assuming the above two conditions, society has maximized its happiness when the MRS = MRT (marginal rate of transformation).

Criticisms:

Does not deal with income distribution

Many things that increase output also change distribution

Based on a static view of efficiency. Long run may be more important

Does not address the morality of the transactions (baby sales)

Arthur Cecil Pigou

(1877 – 1959)

Marshall's successor at Cambridge for 40 years

Concerned with societies' "economic welfare"

Extended Marshall's partial equilibrium analysis

To again allow for more Government

Income Redistribution

You CAN compare utilities between economically similar people

And since Money has declining marginal utility….

The divergence between Private and Social Costs (benefits)
Private marginal cost is the cost to the PRODUCER
Private marginal benefit is the benefit to the CONSUMER
Social marginal cost/benefit applies to SOCIETY as a whole
A useful distinction when Externalities are present

Also did work on forced savings
(Modern societies are biased towards current consumption)
The ability to evaluate current/future consumption is defective
And work on price discrimination
Very important concept, it happens all the time…

Not all competitive markets produce levels of socially optimal output
Because in a Pareto equilibrium, there are no third-party effects
The government should "adjust" costs/benefits
To make private and public MB/MC the same
The Pigovian Tax

Graph of an Externality and Pigovian Tax

Ronald Coase on Externalities….

Ludwig von Mises (Also Hayek)
Austrian, (1881-1973)
Leading Austrian Economist, left Europe in 1940 for the U.S.
Very smart, but also very political and abrasive, somewhat marginalized
The socialism calculation debate
As long as consumer goods were private – markets for them would exist
But what about Capital goods? These could be centrally planned
But with what criteria?
"where there is no free market, there is no pricing mechanism; without a pricing mechanism, there is no economic calculation."
Change is the central issue that an economic system must deal with
And prices convey information about the changes going on
Thus economic calculations are about dynamics, not statics
Capitalistic societies are entrepreneurial, not managerial
Entrepreneurs see changes (through prices) and rearrange resources
To maximize profits (and thus production)
A socialist central planner can't do this

It is not a case of information overload…..
Because the central planner necessarily destroys the very information he needs to efficiently make plans

Oscar Lange (Abba Lerner)
Polish (1904-1965), a dedicated socialist, argued that socialism could work
"On the economic theory of Socialism", 1937, explained how "shadow prices" could work
The Planner would control (own) capital, and could set shadow prices, i.e. ratios of values between different types of capital. Once set, through trial and error,

the planner could adjust those prices to eliminate shortages and surpluses. Firms would follow two rules

Assuming that all prices are fixed, you should

Combine resources so that the av. cost of production for any given output is minimized. This is done by making sure the MRTS is equal for all factors of production.

Output to be fixed where MC = P

The above ensures that we are producing efficiently. Any shortages or surpluses can then be addressed by the central planner, who will change prices of capital to eliminate them.

Problems

For a while, many thought that Lange had won the argument

But two big problems emerged

The information needed to do this was immense. As a practical matter, it seemed impossible to gather it and use it.

The incentives were not there. Regardless of the theory, what did people actually do?

The empirical evidence…….

Kenneth Arrow (1921-) (American, NYC then Stamford)

Did much work in symbolic logic, math, and economics

Eventually started applying economic logic to politics

Arrow's Impossibility theorem

Skip the formal proof for now….

Condorcet Voting….

For example, imagine the U.S. after a terrorist attack. Policy makers (and by extension, the voters they represent) would fall into one of three categories

Hawks: It is their fault, so let's make them pay….

Conquer them, or if you can't, Nuke them, or if you can't, appease them.

Doves: It is our fault, we need to understand them and show them we love them

Appease them, or conquer them, but don't Nuke them…..

Isolationists: It is their fault, we must punish them, but who wants to run an Arab country?

Nuke them, or appease them, or conquer them.

We have three voters, H,D and I

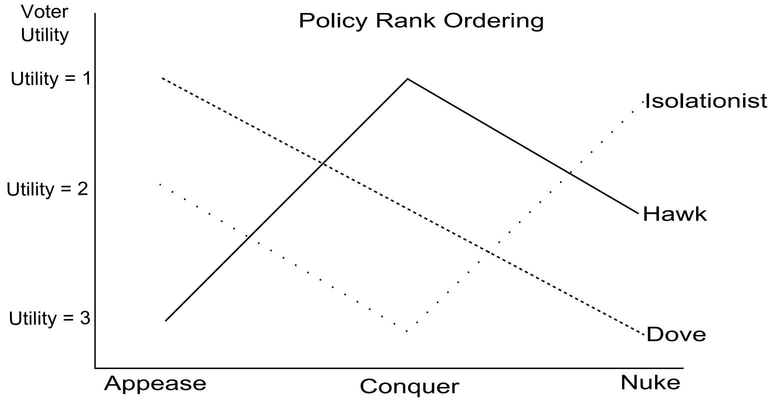
We have three policies, N, C, A

Vote Cycling in the Presence of Dual Peaked Preferences				
Policy/Voter	Hawks	Doves	Isolationists	Policy voted for
Nuke them	2	3	1	N will lose to C
Conquer them	1	2	3	C will lose to A
Appease them	3	1	2	A will lose to N

Our preferences for
H is C > N > A
D is A > C > N
I is N > A > C
Thus, a lower number is our preferred policy, higher numbers represent less preferred policies.

Q: In a pairwise vote, which policy will dominate?

Graphically, we can represent this in the graph to the Right. Note that our Isolationist has two policies that he prefers to conquest, either don't get involved, or Nuke 'em.



The Problem of Condorcet Vote Cycling II

Vote cycling also shows up when we are talking about distributive decisions, and note many decisions about providing a public good are in fact also distributive ones

James M Buchanan

American, Tennessee (1919 - 2013)
Born to rural poverty in the American South
    Became very disdainful of elitist pretensions
Was both a very respected economist, and an outsider
    "left UVirginia, ended up at Mason"

Public Choice and Constitutional Economics
    1964 "The Calculus of Consent" (w/Gordon Tullock)
    A modern restatement of Wicksell's forgotten work
    That Buchanan didn't realize was groundbreaking…

Public Choice Economics
    Homo-economicus,
        Each individual has varying tastes, is rational, and purposeful
        And through markets, engages in exchange to max. utility
        And Homo-politicus is different how?
    Buchanan fought the "Benevolent Despot"
        Lose the "we"….
    Pubic choice helps to explain
        The fall of communism
        Budget Deficits and "one-eyed Keynesianism"
        Logrolling and voting behavior
        Rent Seeking (Gordon Tullock)

The behavior of bureaucracies

Critique of conventional Welfare Economics (the "benevolent despot")

Nobody knows the utility curves of individuals

So how can we create a social welfare function?

And even if we could, so what…

The public sector is not a reliable method of achieving it

You can't talk about the need for a government to solve market failure, without addressing the question of government failure.

Constitutional Economics

What makes for a "good" constitution?

The "rules of the game", but don't predetermine outcomes

Limitations (what can't be played with)

Side deals (to get people to agree)

Amartya Sen (Indian)