

Welfare Economics and General Equilibrium

- ❖ WHAT IS WELFARE?
- ❖ **CRITERIA FOR MEASURING WELFARE IMPROVEMENT**
- ❖ **PARETO OPTIMUM CONDITIONS**

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Pareto criterion

- A change is a welfare improvement if at least one person is better off without making anyone worse off.
- Three Pareto optimum conditions:
 - Consumption
 - Production
 - Product Mix

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- Pareto optimum and perfect competition

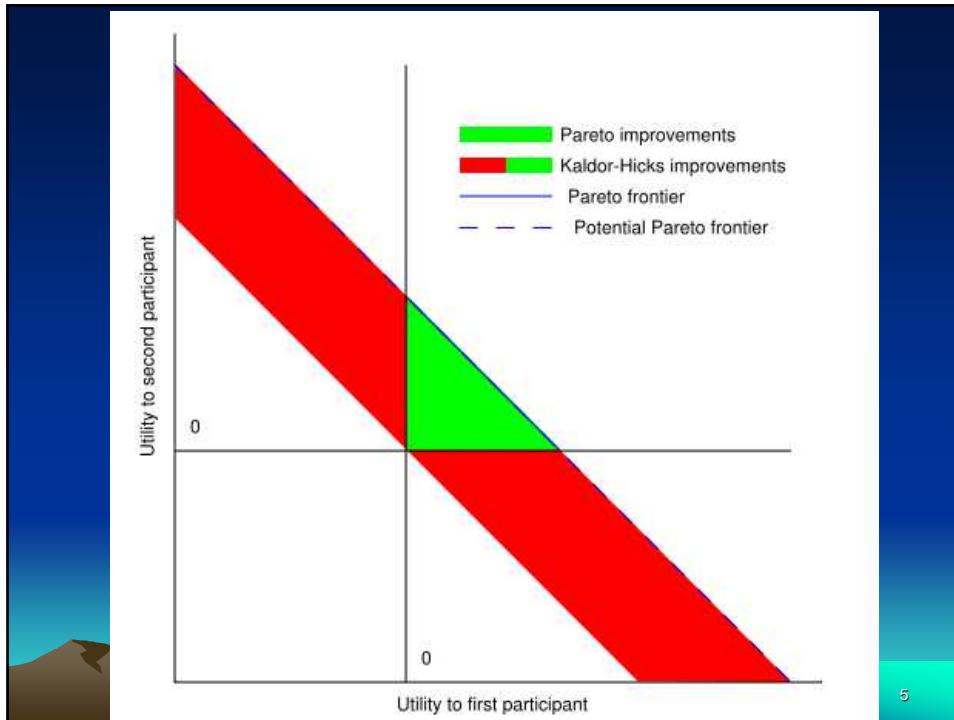


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What's wrong with Pareto optimum and Pareto criterion?

1. Preserves status quo
2. Pareto optimum is not social welfare maximum – other goals of society – equity? income distribution? Altruism?

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Status quo problem: what to do? Other criteria?

- Kaldor

an activity will contribute to Pareto optimality if the maximum amount the gainers are prepared to pay is greater than the minimum amount that the losers are prepared to accept.

- Hicks

an activity will contribute to Pareto optimality if the maximum amount the losers are prepared to offer to the gainers in order to prevent the change is less than the minimum amount the gainers are prepared to accept as a bribe to forgo the change.

- Scitovskv Kaldor-Hicks

Pareto optimum is not social welfare maximum

What to do:

1. Social welfare function?
2. Voting?

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Arrow's Impossibility Theorem

I: $A > B > C$

II: $B > C > A$

III: $C > A > B$

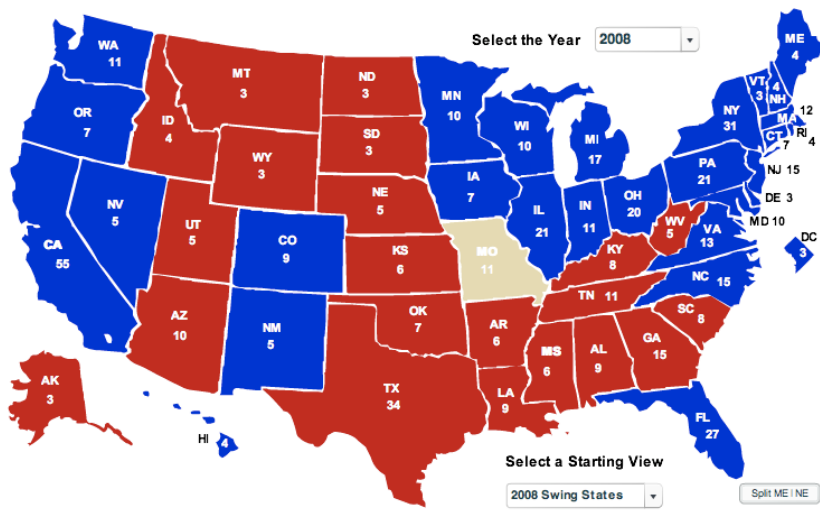
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What to do?

- Preferential voting
- Vote with your feet

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The 'swing states' view below reflects projected results from the election. There is still some doubt on the winner of the final split electoral vote for Nebraska. If Obama were to win this, his EV total would increase by one and the McCain EV total would decrease by one.



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Arrow's Impossibility Theorem

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Problem: Perfect Competition leads to Pareto Optimum but

- Pareto optimum is not Social Welfare Maximum
- Market Failure

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