

Exchange, Pareto, and Noxious Markets

Markets III: Free Exchange
PPE 101

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The Efficiency Argument

EFFICIENCY ARGUMENT

- P1** In a free market, participants voluntarily exchange goods and services.
 - P2** If X is voluntarily exchanged for Y, then the participants of the exchange are made better-off and no one is made worse-off.
 - P3** A distribution of goods and services that makes some better-off and makes no one worse-off is always a better distribution.
-
- C** A free market results in a better distribution of goods and services.

The Efficiency Argument

EFFICIENCY ARGUMENT

- P1 In a free market, participants voluntarily exchange goods and services. **The Exchange Claim:**
- P2 If X is voluntarily exchanged for Y, then the participants of the exchange are made better-off and no one is made worse-off.
- P3 A distribution of goods and services that makes some better-off and makes no one worse-off is always a better distribution.
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ARGUMENT FOR THE EXCHANGE CLAIM

- P1 X would be voluntarily exchanged for Y only if the person who has X (Person A) prefers having Y to having X and the person who has Y (Person B) prefers having X to having Y ($Y \succ_A X$ and $X \succ_B Y$).
- P2 If $Y \succ_A X$ and $X \succ_B Y$ then both A's and B's preferences are better satisfied by engaging in the transaction than by not.
- P3 Satisfying a preference makes one better-off.
- P4 No one else is affected by the exchange.
-
- C If X is voluntarily exchanged for Y, then the participants of the exchange are made better-off and no one is made worse-off.

The Efficiency Argument

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Free Exchange

Each voluntary exchange, makes both parties happier (without any change in the total wealth available).

Recall:

The Ice Cream Activity



Free Exchange

Each voluntary exchange, makes both parties happier (without any change in the total wealth available).

If the exchange doesn't make anyone worse off, then the allocation of goods that results from the exchange **Pareto-dominates** the one prior to the exchange.

Pareto-dominates: No one is worse off, some are better off.

The Fundamental Theorems

The First Fundamental Theorem of Welfare Economics:

The allocation resulting from any perfectly competitive equilibrium is **Pareto-efficient**.

Pareto-efficient: it's impossible to make anyone better off without making someone worse off.

X is *Pareto-efficient* = X is not Pareto-dominated.

Review: Pareto-efficiency

Pareto-Efficiency

Which, if any, of these allocations is *Pareto-efficient*?

		People		
		A	B	C
Allocation 1	...	3	0	5
Allocation 2	...	1	1	5
Allocation 3	...	2	2	5

Pareto-Efficiency

Which, if any, of these allocations
is *Pareto-efficient*?

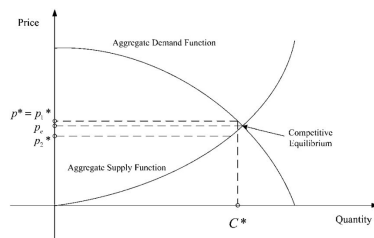
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The Fundamental Theorems of Welfare Economics

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The allocation resulting from any perfectly **competitive equilibrium** is Pareto-efficient.



The Fundamental Theorems

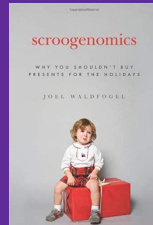
The First Fundamental Theorem of Welfare Economics:

The allocation resulting from any perfectly **competitive equilibrium** is Pareto-efficient.

People engaging in
voluntary exchange.



Question: Is Gift Giving Inefficient?



WHY THE GRINCH WAS RIGHT

Magic City
WEEKEND



The Fundamental Theorems

The First Fundamental Theorem of Welfare Economics:

The allocation resulting from any perfectly **competitive equilibrium** is Pareto-efficient.

- (1) Full Information
- (2) No Transaction or Enforcement Costs
- (3) No Externalities
- (4) Traders are rational
- (5) Products are undifferentiated

The Fundamental Theorems

The First Fundamental Theorem of Welfare Economics:

The allocation resulting from any perfectly **competitive equilibrium** is Pareto-efficient.

(We'll explore these assumptions in more detail later on.)

Pareto-efficiency: Is It Good?

Pareto-efficiency

Question: If an allocation of goods is Pareto-efficient, is it good?

Pareto-efficiency

Question: If an allocation of goods is Pareto-efficient, is it good?

Consider: *Inequality*.



Pareto-efficiency

Question: If an allocation of goods is Pareto-efficient, is it good?

Consider: *Inequality*.



A Pareto-efficient allocation of 100 cookies is that I have them all and you have none.

The Second Fundamental Theorem of Welfare Economics

The Fundamental Theorems

The Second Fundamental Theorem of Welfare Economics:

In a perfectly competitive market, any Pareto-efficient allocation whatsoever may be achieved with a suitable distribution of initial endowments.

The Fundamental Theorems

“The two Fundamental Theorems of Welfare Economics, then, seem to say this: *although not every distribution resulting from free exchange will be morally satisfactory, some distribution achievable with free exchange will be.*” Gibbard, pg. 26



The Fundamental Theorems

“The two Fundamental Theorems of Welfare Economics, then, **seem** to say this: *although not every distribution resulting from free exchange will be morally satisfactory, some distribution achievable with free exchange will be.*” Gibbard, pg. 26



What Would It Take to Reap the Benefits of the Second Theorem?

The Fundamental Theorems

“... [R]eaping the benefits of the Second Fundamental Theorem would require a **perfect omniscience** on the part of whomever distributed the ‘initial endowments.’”

Gibbard, pg. 27



The Fundamental Theorems

The Best We Can Hope For:

Tolerable, but Pareto-inefficient distributions

Gibbard, pg. 27



Gibbard's Conclusion

“...all that can be reasonably supported ... is a mitigated system of **free exchange**, i.e., a price system with **taxation** to mitigate **income inequalities**.”

Gibbard, pg. 28



The Ethical Limits of the Market

The Efficiency Argument

Free exchange (under certain conditions) has an important property: it leads to *Pareto improvements*.

Setting up a market of free exchanges, then, has something going for it.

But there are some goods and services about which people are uncomfortable producing and distributing with markets.

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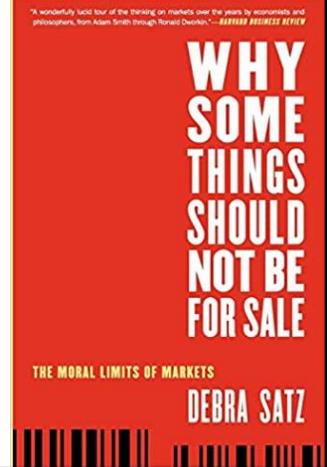
The Ethical Limits of the Market

Should we have a market in everything?

What is wrong with markets in everything? What is it about the nature of particular exchanges that concerns us, to the point that markets in some goods appear to be clearly undesirable? How should our social policies respond to such markets? Where and for what reasons is it appropriate to regulate a market, and when should we seek to block it?



Debra Satz



The Ethical Limits of the Market

TABLE 1. What Makes a Market Noxious?

Source: Weak Agency

Inadequate information about the nature of and/or consequences of a market; others enter the market on one's behalf

Outcome: Extreme Harms for Individual

Produces destitution; produces harm to the basic welfare and/or agency interests of the individual

Source: Vulnerability

Markets in a desperately needed good with limited suppliers; markets with origins in poverty and destitution; markets whose participants have very unequal needs for goods being exchanged

Outcome: Extreme Harms for Society

Promotes servility and dependence; undermines democratic governance; undermines other regarding motivations

