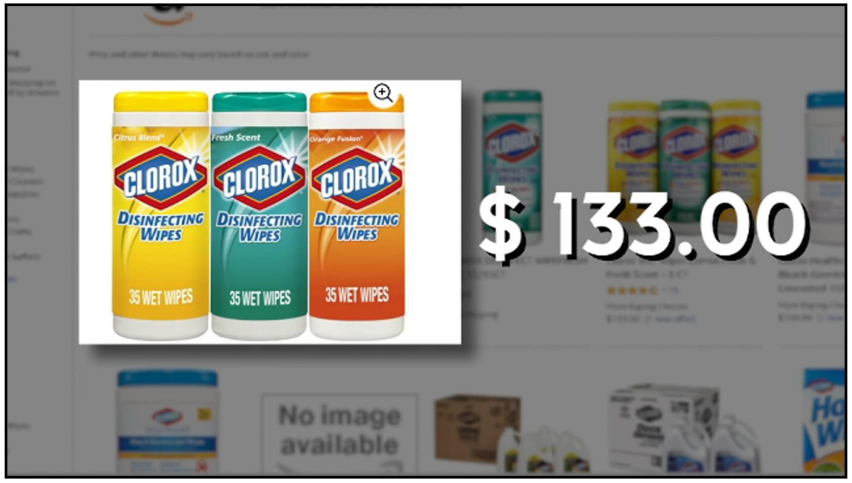
The Fundamental Theorems of Welfare Economics

Choice, Commerce, and Conflict
Ryan Doody

Contents:

The Ethics of Price Gouging



Price Gouging

What Is It?

When suppliers charge *very high* prices for certain goods or services. (Higher prices than normal…)

Why Does It Happen?

Decrease in supply/increase in demand → Increase in $$$

Should It Be Banned? Is It Morally Wrong?

Price Gouging

Should It Be Banned? Is It Morally Wrong?

(What would Hayek say?)

Price Gouging

Should It Be Banned? Is It Morally Wrong?

What is the argument Zwolinski is making?

How might you respond to this argument?

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Observation 1: Wealth inequality

Observation 2: Time lag

Price Gouging

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What is the argument Zwolinski is making?

How might you respond to this argument?

Observation 1: Wealth inequality

Observation 2: Time lag

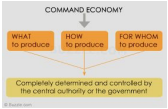
Why might this matter?

Market Efficiency

Free Exchange

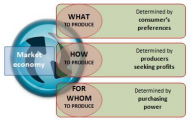
The Fundamental Economic Problem:

Given the scarcity of resources, what goods and services should be produced and how should they be allocated?



Ways of Approaching the Problem:

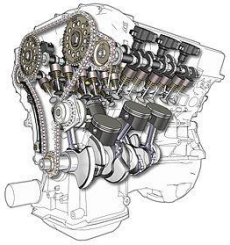
- Central Planning
- Markets



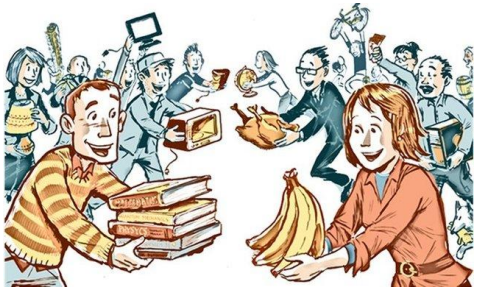
Free Exchange

In addition to addressing the **information problem** (with prices), markets are **efficient**.

What does that mean?



Activity



Free Exchange

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

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How? Why?

Free Exchange 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.

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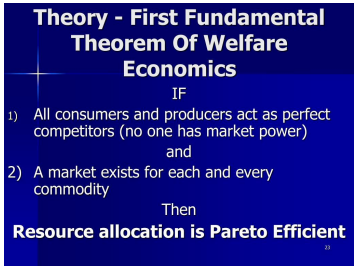
Pareto-dominates: No one is worse off, some are better off.

The Fundamental Theorems of Welfare Economics

The Fundamental Theorems

The First Fundamental Theorem of Welfare Economics:
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.

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

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

Pareto-Efficient

Pareto-Efficiency

Which, if any, of these allocations is best?

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

Pareto-Efficiency

Which, if any, of these allocations is best? (What about Allocation 2?)

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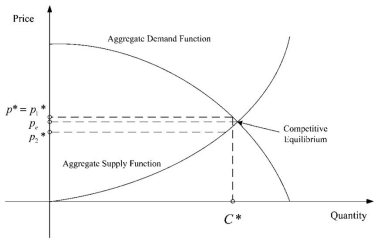

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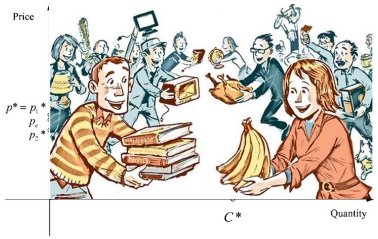
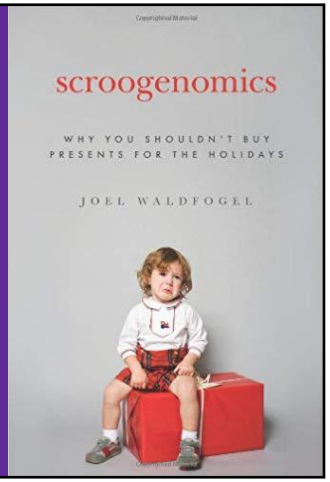


People engaging in voluntary exchange.

Question:
Is Gift Giving Inefficient?



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?

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Consider: Inequality.

Pareto-efficiency

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

Pareto-Efficiency

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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

Next Time:
The Ethical Limits of the Market

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.

The Efficiency Argument

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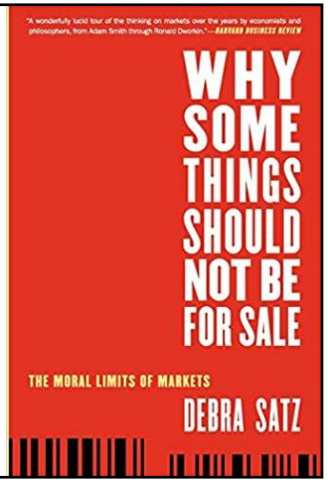
The Ethical Limits of the Market

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

Should we have a market in everything?

What Should Not Be For Sale?

Examples:

Why Should Some Things Not Be For Sale?

The Efficiency Argument

Thousands of people die each year waiting for kidneys.

A market for kidneys would increase the supply, which would benefit those who need them.

A market for kidneys would benefit suppliers and demanders.

Isn't it a win-win?

The Efficiency Argument

EFFICIENCY ARGUMENT

P1 In a free market, participants voluntarily exchange goods and services.

The Exchange Claim:

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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.

Why Should Some Things Not Be For Sale?

Two Approaches:

1. Intrinsic features.
   The intrinsic value of the good/service is *corrupted* by the existence of a market for it.

2. Extrinsic features.
   The existence of markets in some goods will have negative consequences.

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The Ethical Limits of the Market

In reality, this view of market neutrality is overstated. Some goods are changed or destroyed by being put up for sale. The most obvious examples of this phenomenon are love or friendship. A person who thought that they could buy my friendship would simply not know what it means to be a friend. A proposal to buy love, prizes, honors, friends, or divine grace is conceptually incoherent: it is the nature of these things that they cannot be bought.

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This worry about markets is sometimes posed in terms of the metaphor of infection – that market norms and relations will spill over and contaminate nonmarket realms such as friendship and love. Thus, it has been alleged that markets erode our appreciation of the true value of other people, since they lead us to think of goods and people as exchangeable items. This wide interpretation of the market's negative effects on human flourishing has only weak social scientific support. There is little evidence that people are greedier in market societies than they were in peasant economies, that they devalue love and friendship, or that they are now less likely to engage in moral behavior than in the past (Lane, 1991).