David Youngberg

Econ 304—Bethany College

**Lecture 04: Efficiency & Gains From Trade**

1. Equality
   1. A *social welfare function* addresses this concern by assigning weights to people’s utility functions and then maximizing total utility to determine what is socially desirable.
2. Welfare Theorems
   1. There are two theorems that come out of general equilibrium theories. We call these “welfare theorems.” Here, “welfare” has nothing to do with the government program. “Welfare” in economics-speak is about the social totals, or aggregate wealth.
   2. *First Fundamental Welfare Theorem*—market equilibria are Pareto efficient. By the basics of exchange, if something isn’t Pareto efficient then people will trade. Since the economic actors are changing of their own volition, this is not equilibrium.
      1. Implication: competition tends towards efficient outcomes (the invisible hand); one does not need central planning to not waste resources.
   3. *Second Fundamental Welfare Theorem*—every efficient outcome can be supported by some set of prices. (This is the converse of the first.)
      1. Implication: To reach a particular outcome, all you need is the right redistribution of the *initial* endowment.
3. Philosophies of equality
   1. *Egalitarian*—everyone gets the same amount of stuff; forget utility
      1. Problem: May not even be on the contract curve! I get the same amount of tomatoes as you even though I hate tomatoes
   2. *Utilitarian*—maximize total utility; no weights
      1. Problem: Did WWII have too few Nazis?
   3. *Rawlsian*—society must maximize benefits going to society’s most disadvantaged group; put a big weight on the poorest people
      1. Problem: How do you not create incentives to be poor?
   4. *Nozick*—as long property is justly acquired and voluntarily exchanged, the result is optimal; put a small weight on those who benefit from taxes, government programs, etc.
      1. Problem: How do you provide public goods?
4. Applications
   1. Both the welfare theorems and the philosophies of equality inform us how to approach major economic issues such as redistribution and taxation.
      1. There’s no such thing as a general glut. It is impossible to have involuntary unemployment in a well-functioning economy. This is obviously controversial and some schools of thought (e.g. Keynesianism) reject GE and the welfare theorems because of this sort of conclusion.
      2. If you’re going tax anything, tax endowments (like inheritance); that will have little distortion. In fact, one could argue for a 100% (or near 100%) inheritance tax based on this.
      3. How you approach redistribution depends on what you prioritize. There are no free lunches and sometimes making us wealthier means letting others die or stay poor. (For example, if someone cannot afford an expensive treatment for an illness, it might be more efficient to let them die…see end-of-life care.)