

LECTURE 5

Theories of Social Justice, the State and Economic Inequality

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Organization of the lecture

- ⊛ Social optimality in the context of the two Theorems of Welfare Economics
 - Lump sum taxes
 - The Pareto dominance criterion and its problems
- ⊛ Why we need social welfare functions
- ⊛ Theories of society
 - Libertarian views
 - Liberal theories of society
 - Collectivist views
 - Implications for the role of the state
- ⊛ Social welfare functions and "social indifference curves"
- ⊛ Welfare economics in economists' practice

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Social Optimality

- The policy analysis begins by assuming that there is a social planner, who makes judgements over allocations of utility
- Such a planner (policy maker) will want to achieve a Pareto-efficient allocation
- Suppose that the social planner has chosen as her preferred outcome a particular Pareto-efficient allocation.
- The Second Theorem of Welfare Economics shows this is achieved by decentralizing the chosen allocation
- The only intervention is a lump-sum redistribution of endowments to ensure that consumers have the required incomes and ensure market competition.
- Then applicable economic policy reduces to lump-sum redistribution and the formulation of a set of rules that guarantee competition.

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Social Optimality

- The first issue is the selection of one Pareto-efficient allocation from the contract curve
- There are number of ways this can be done
 - Voting over the alternative allocations or for the election of a body (a 'government') to make the choice (public choice literature)
 - Consumers could agree for the allocation to be chosen at random or they might hold unanimous views (public choice literature)
 - There may be a benevolent social planner who has preferences over the alternative allocations based on the utility levels of the consumers
- We will assume the third.

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Social Optimality

- A benevolent social planner will select an allocation on the contract curve
- In Fig. 1 each point on the contract curve is associated with a pair $\{U^1, U^2\}$
- As we move from the bottom-left corner of the Edgeworth box to the top-right, the utility of consumer 1 rises and that of 2 falls.
- The set of points generates the *utility possibility frontier*
- Points *a* and *b* are Pareto-efficient but point *c* is inefficient

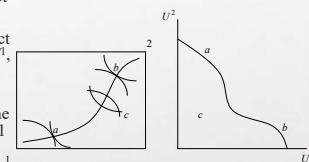


Figure 1: Utility possibility frontier

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Social Optimality

- How will the social planner choose among the different points of the utility possibility frontier?

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Social Optimality

- The allocation is chosen that achieves the highest level of social welfare
- Social indifference curves represent constant levels of social welfare
 - The shape captures the equity/efficiency trade-off
- In Fig. 2 point o on the utility possibility locus achieves the highest social indifference curve
 - This is the *socially optimal* division of resources



Figure 2: Social optimality

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Social Optimality

- Given the socially optimal allocation the Second Theorem is applied
- The socially optimal allocation is traced back to a point in the Edgeworth box
 - This allocation is then decentralized
- The Second Theorem allows the economy to achieve the outcome most preferred by its social planner
 - Socially optimal allocation is both efficient and equitable relative to the social welfare function
 - The only policy is the redistribution of endowments

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Social Optimality

- Two questions arise:
 1. Are lump-sum taxes feasible?
 2. What determines the shape of the social indifference curves?

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Lump-Sum Taxes

- A transfer or tax is lump-sum if a consumer cannot affect the size of the transfer by changing behaviour
 - taxing each consumer a fixed amount is a lump-sum tax
- The value of lump-sum taxes rests partly on their imposition being costless
 - far from the case with the UK poll tax
 - collecting information on residential address prohibitively expensive
 - the tax base is highly mobile
- The focus is on optimal lump-sum transfers
 - taxes are optimal when resulting equilibrium is socially optimal
 - social planner must predict the equilibrium for all income levels
 - requires knowledge of the consumers' preferences
 - social planner must know the value of each consumer's endowment
- These economic characteristics are private information
 - known only to the individual consumers

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Lump-Sum Taxes

- Lump-sum taxes may be differentiated according to characteristics such as sex, age or eye-colour
 - but these are not those that are directly relevant.
- Since the characteristics are not observable the social planner must
 - either rely on consumers honestly reporting them
 - or the characteristics must be inferred from the actions
- In the latter case there is invariably scope for changes in behaviour which implies the taxes are not lump-sum.
- When reports provide information unobserved characteristics cannot form a basis for taxation unless the tax scheme leads to truthful revelation

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Lump-Sum Taxes

- Interaction between taxes and reporting
 - let a consumer's endowment be determined by their IQ
 - if the level of tax is inversely related to IQ
 - an IQ test would not be cheated
 - incentive is to maximise the score
 - if taxes were positively related to IQ
 - testing would be manipulated by the high IQ consumers intentionally doing poorly
 - mean level of tested IQ would be expected to fall considerably.
- Second case
 - taxes are not incentive compatible
 - potential for misrevelation of characteristics
- Such problems will always be present in any attempt to base the transfers on unobservable characteristics

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Aspects of Pareto efficiency

- Can we avoid the issue of comparing individual utilities and trying to place a "social value" on each person's utility?
- One way out is Pareto efficiency.
- This concept was introduced by the Italian economist Pareto at the beginning of the twentieth century
- The innovation it provided was a means of comparing economic states without requiring interpersonal comparisons of utility
- This is both its strength and its main weakness

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Pareto dominance

- Seek to identify situations of dominance. Conclusions do not change with changes in the welfare criteria. Welfare statements are limited to changes that everybody better off or at least no one worse off.
- Hard to imagine why any policy-maker would not try to raise the welfare of at least one consumer without harming any other.
- Pareto improvement example (100, 201, 500) beats (100, 200, 400).
- A situation where there are no further possibilities for Pareto improvements is Pareto efficient.

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Aspects of Pareto-Efficiency

- More formally, consider
 - a set of alternative economic states $S = \{s_1, s_2, \dots\}$
 - a set H , indexed $h = 1, \dots, H$, of consumers
- Consider a move from economic state s_1 to state s_2 . This is defined as a Pareto improvement if it makes some consumer(s) strictly better off and none worse off.
- Formally, $U^h(s_2) > U^h(s_1)$ for at least one consumer h , and

$$U^h(s_2) \geq U^h(s_1) \text{ for all consumers } h = 1, \dots, H.$$
- This is a way of converting the set of individual preferences of the consumers into social preferences over the states.

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Aspects of Pareto-Efficiency

- Consider the division of a fixed quantity of a single good between two people where both people prefer more to less
 - every division of the good is Pareto efficient
 - starting from any division a change in the allocation that provides more to one person can only do so by taking it away from the other.
- This simple example reveals two deficiencies of Pareto efficiency
 - extreme allocations, such as giving all the good to one person, can be Pareto efficient so Pareto efficiency does not imply equity or fairness
 - there can be many Pareto efficient allocations

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Aspects of Pareto-Efficiency

- The contract curve shows the set of Pareto efficient allocations in the Edgeworth box
- there is generally an infinite number of Pareto efficient allocations
- the Pareto preference ordering does not select a unique optimal outcome
- the Pareto efficient allocation in the bottom-left corner of the box is highly inequitable

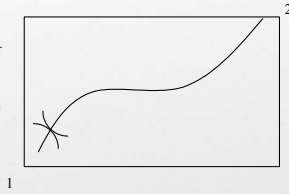


Figure 3: Efficiency and inequity

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Aspects of Pareto efficiency

- The Pareto preference ordering does not always provide a **complete ranking of the alternative states**
- Allocations s_1 and s_2 cannot be compared
- s_3 is Pareto preferred to both s_1 and s_2
- Neither $s_1 \succeq_p s_2$ nor $s_2 \succeq_p s_1$ holds
- Incomparability \neq indifference
- Indifferent between s_1 and s_2 means they are judged equally good
- Incomparability means they cannot be ranked.
- The ranking cannot therefore be complete

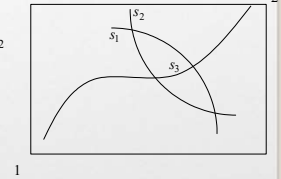


Figure 4: Incompleteness of Pareto ranking

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Problems with Pareto dominance criterion

- Incomplete ordering.
- Even a very modest loss of one person prevents us from reaching any conclusion.
 - Preventing the burning of Rome would have made Emperor Nero feel worse off, thus we cannot conclude that burning is a mistake.
 - Sen (1970) "a society or an economy can be Pareto efficient and still be perfectly disgusting".
- It is based on individual welfares. Social judgments may override individual welfares, e.g. with merit goods.

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Problems with Pareto dominance criterion

- Social welfare is not always a non-decreasing function of individual welfare.
- Are there situations in which we regard an improvement of one person as a worsening for society?
- Egalitarianism as an objective per se, we may view negatively additions to the well-being of the rich if it takes them too far away from the rest of society.
- Plato: 'if a state is to avoid ... civil disintegration ... extreme poverty and wealth must not be allowed to rise in any section of the citizen-body, because both lead to disasters. This is why the legislator must announce now the acceptable limits of wealth and poverty'.
- Concern about *distance*. When is it regarded as excessive?
 - UK example top 1% of earnings / median earnings was <4 in 1991
5.25 now

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Beyond Pareto efficiency

- Basic mechanism behind these difficulties is the fact that the Pareto criterion can only judge between alternative states if there are only gainers or losers as the move is made between the states
- If some gain and some lose then the criterion is of little value
- Gains and losses are invariably a feature of policy choices and much of policy analysis consists of weighing-up the gains and losses.
- Tax and expenditure policies of the state, for example, might aim at redistributing income from rich to poor (progressive taxation and expenditure programmes targeted at the poor).
- In this respect the Pareto criterion is inadequate as a basis for policy choice

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Welfare functions

- The social planner must, therefore, employ a social welfare function in order to derive the social optimum.
- The form of the social welfare function will determine the shape of the "social indifference curves".
(Note similarity with consumer's utility function that generates the form of the consumer's indifference curves)
- The social welfare function captures the **ethical objectives** of the society.
- So we need to study theories of society developed by moral philosophers.

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A STEP BACK Detecting bias in arguments

- A useful distinction is the one between Positive and normative economics
- **Positive economics** deals with **objective explanation** and the testing and rejection of theories
- **Normative economics** express an **opinion** about what ought to be, i.e. they carry **value judgments**.

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Some examples

- “A reduction in income tax will improve the incentives of the unemployed to search for work.”
- “Poverty in the UK has increased because of the fast growth of executive pay.”
- “The government should increase the national minimum wage to €6 per hour in order to reduce relative poverty.”
- “The government is right to introduce a ban on smoking in public places.”

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Positive and Normative Economics

- There are two different reasons why economists may disagree.
- We may disagree about the way in which we believe that the economy works.
- Or, we may disagree about the criteria to be applied in judging economic performance.

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Positive and Normative Economics

- For example, a 2% tax was recently introduced in France on the sale of fish, with the proceeds used to compensate fishermen for the rise in the price of diesel.
- Disagreement of the first kind: who will bear the tax? The consumers or the fishermen? Depends on how we view the determination of prices in the market and on the relative elasticities.
- Disagreement of the second kind: Is there a reason for giving priority to the compensation of fishermen? What welfare criteria should we apply?

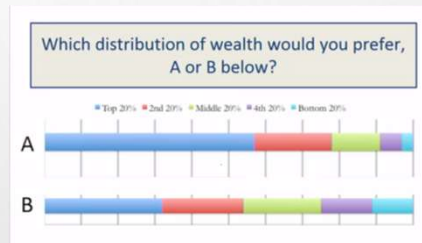
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Is economics a moral science?

- Caring about social justice is matter of ethics. Is economics a moral science?
- “Economics deals with ascertainable facts; ethics with valuations and obligations. The two fields of enquiry are not on the same plane of discourse.” (Lionel Robbins, *An Essay on the Nature and Significance of Economic Science*, 1932, p. 132)
- “Economics is essentially a moral science. That is to say, it employs introspection and judgement of value.” (Lord Keynes, writing to Sir Roy Harrod, 4 July 1938)

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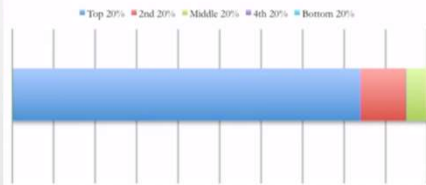
From the lecture of Robert Reich on 24/1/2018 in
University of California at Berkeley



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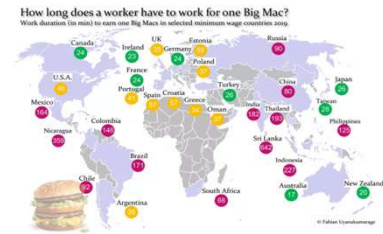
From the lecture of Robert Reich on 24/1/2018 in
University of California at Berkeley

When in fact, the *real* distribution is:



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How much time (in minutes) work buy you a Big Mac?
(2019)



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Theories of society and theories of justice

- A society is a co-operative venture for the mutual advantage of its members
- It generally contains both an identity of interests and conflicts of interest between individuals and groups
- The institutions of any society (its constitution, laws, and social processes) profoundly influence a person's life chances
- The purpose of a theory of society is to offer principles which enable us to choose between different social arrangements

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Theories of society

- Theories of society can be grouped in three types:
 1. Libertarian theories. Heavy weight is given to freedom, strong support to private property and the market mechanism.
 2. Liberal theories. Philosophy of utilitarianism. Societies are analysed in terms of their individual members.
 3. Collectivist theories. Marx and democratic socialists. Society consists of social classes, defined in terms of their relation to the means of production.

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1 Libertarian views

- The Libertarian aim: to maximise individual liberty
- Natural rights libertarians (e.g. Nozick) argue that state intervention is *morally wrong* except in very specific circumstances
- Empirical libertarians (Hayek, Friedman) argue that state intervention will *reduce total welfare*; Hayek argues that the pursuit of social justice will destroy the market order

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1 Libertarian views: natural-rights libertarians

- Nozick: everybody has the right to distribute the rewards of his own labour. Defence of private property on moral grounds.
- A person is entitled to a holding if:
 - a. he has acquired it through earnings
 - b. he has inherited it (it was itself justly acquired)
 - c. he acquired it illegally and the government has the right to take it away and redistribute it.

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1 Libertarian views: natural-rights libertarians

- Role of the state as a “nightwatchman” with one goal: the provision of one public good, i.e. defence of persons and property, including the enforcement of contracts
- Taxation is “theft” (it extracts from people money they have legitimately acquired) and “slavery” (people are forced to spend part of their time working for the government).

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1 Libertarian views: empirical libertarians

- Hayek’s theory:
 - Primacy of freedom, defined as absence of coercion or restraint, i.e. political liberty, free speech, economic freedom.
 - Value of the market mechanism
- “The market is a procedure which has greatly improved the chances of all to have their wants satisfied, but at the price of all individuals... incurring the risk of unmerited failure...”
- The pursuit of social justice is fruitless and harmful.
- There is no such thing as social justice. The market is an impersonal mechanism like “nature”, like a game with winners and losers. It’s results can be good or bad but never just or unjust. Winning the lottery or dying young can be regarded just or unjust only if someone else is responsible for it.

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1 Libertarian views: empirical libertarians

- The pursuit of equality will reduce liberty. “The more dependent the position of individuals is seen to become on the actions of governments, the more they will insist that the government should aim at some recognisable scheme of distributive justice... So long as the belief in “social justice” governs political action, this progress must progressively approach nearer and nearer to a totalitarian system”
- The “New Right” (1970s and ‘80s), e.g. Thatcher supported these views. Great faith in individuals (large role for markets) and little faith in government (small role for the state).

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1 Libertarian views: empirical libertarians

- The Friedman doctrine : “the social responsibility of business is to increase its profits”
- In his book *Capitalism and Freedom* (1962) he claims that the sole responsibility of business in society is to maximize its profits within the legal limits.

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1 Libertarian views: main criticism

- It has a view of markets as a game with winners and losers. But it can be argued that it is a game without rules, like a boxing competition where participants are not divided into different classes by weight.
- Market economy or market society? Should all voluntary contractual exchanges be allowed among consenting adults?

M.Sandel, *The Tyranny of Merit*, 2021

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2 Liberal theories of society

Three premises:

1. Capitalism is efficient, but has major costs in terms of poverty and inequality.
2. The government can ameliorate these costs.
3. A combination of markets and government action can jointly maximize efficiency and equity.

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2.1 Utilitarianism

The utilitarian aim: policy should seek to maximise the total utility of members of society.

Maximising total welfare has two aspects:

- Goods must be produced and allocated efficiently.
- Goods must be distributed in accordance with equity.

Under certain conditions utilitarianism leads to equality, but what happens if individuals have different utility functions or if we cannot measure utility cardinally?

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Simple Utilitarianism

- The *utilitarian social welfare function* is:

$$W = F(U_1, U_2, \dots, U_n)$$

- Which depends on all n members of society. One specific function form is:

$$W = U_1 + U_2 + \dots + U_n$$

- This special case is referred to as an *additive social welfare function*.

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2.1 Utilitarianism: some criticisms

- Is utility capable of precise definition?
- Does interpersonal comparison of utility have any meaning?
- Whose utility counts? Future generations, animals?
- It leads to unjust outcomes. If B derives less pleasure from life because he has major health problems, a utilitarian would give him less income.

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2.1 Utilitarianism: some criticisms

- The impossibility of a Paretian liberal. Individual freedom and maximising total welfare (utilitarianism) might be incompatible objectives.
 - What happens if the action of one person affects the welfare of another person for aesthetic or moral reasons? (e.g. men with long hair, a wealthy person with a yacht in Monte Carlo, people living together before getting married, soft drugs, etc.)
 - What does this imply for public policy? Should these interdependencies be taken into account? If yes, people will be penalised for carrying out private personal acts which affect others only because thinking makes it so. Utilitarianism can become illiberal doctrine.
 - If such preferences are ignored, policy is no longer decided only on a utilitarian basis. Someone has to decide which forms of interdependencies are allowable and which not.

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Jeremy Bentham (1748-1832)



Bentham: "The highest principle of morality, whether personal or political morality, is to maximise the general welfare or the collective happiness, or the overall balance of pleasure over pain, in a phrase "maximise utility""

Principle of the greatest good for the greatest number

This is the rationale of cost-benefit analysis, you can place a monetary value on anything

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What's the right thing to do?



AS THE MINOSETTE WENT DOWN.

From Illustrated London News, 20 September 1884.

Case against T. Dudley, Stephens, Brooks and Parker

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Phillip Morris case study

https://www.tobaccofreekids.org/assets/content/what_we_do/industry_watch/philip_morris_czech/pmczechstudypdf

Figure 2: The public finance balance of smoking in the Czech Republic in 2009 is estimated at -1,813 mil. CZK

Income and positive external effects	23,467 mil. CZK
Savings on lowering the alcohol	23,467 mil. CZK
Provision of tax revenue savings due to early mortality	136 mil. CZK
Health care cost savings due to early mortality	368 mil. CZK
Consumer duty	314 mil. CZK
Corporate income tax	797 mil. CZK
VAT	3,539 mil. CZK
Excise tax	15,640 mil. CZK
Standing related public finance costs	15,647 mil. CZK
Fair indexed costs	49 mil. CZK
Lost income tax due to higher mortality	1,367 mil. CZK
Short run of each related public finance costs	1,607 mil. CZK
ETS related health care costs	1,141 mil. CZK
Standing short health related health care costs	11,433 mil. CZK
NET BALANCE	-1,813 mil. CZK

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2.2 Rawls on social justice

- Contrary to Nozick, for Rawls the natural right is “social justice”.
- Justice is desirable:
 - For its own sake on moral grounds
 - Because institutions will survive only if they are perceived to be just

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2.2 Rawls on social justice

- The original position and the Veil of Ignorance
- Assumptions:
 - Every individual is self-interested
 - All individuals come together to negotiate principles to determine the distribution of goods, and once agreed, must abide to the same principles
 - All individuals are deprived of knowledge about himself – his characteristics, endowments, position in society, country they will live in, etc.
- So, negotiators seek to advance their own interest, but are unable to distinguish them from anyone else's.
- Veil of ignorance: important in order to distance ourselves from self-interest (example of hijackers)

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2.2 Rawls on social justice

- Any principle of justice is considered by negotiators (e.g. pursue the interest of the strongest, maximise total utility)
- Rawls argues that the rational negotiator will reject these because under each he might systematically be underprivileged.
- The only rational choice negotiators will make will accord to the...
- The Rawlsian aim: policy should benefit the least well-off (imagine you turn out to be the least privileged inhabitant of Ghana)

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2.2 Rawls: the two principles of justice

- The negotiators will rationally and unanimously choose two follow two principles:
- **The liberty principle.** “Each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others” (Rawls, 1972).
- **The difference principle.** Social and economic inequalities are to be arranged so that they to the greatest benefit of the least advantaged (so give an airplane to a rural doctor)
- Absolute priority is given to the first principle.

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The Maximin Criterion

- The *Rawlsian social welfare function* is:

$$W = \text{Minimum}(U_1, U_2, \dots, U_n)$$
- Social welfare in this case depends only on the utility of the person who has the lowest utility.

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2.2 Rawls and utilitarianism

- Rawls is an explicit opponent of utilitarianism
- He regards it as illogical (rational individuals would never agree on such a principle) and unjust.
- Different implications for policy.
- Example:
A policy change makes someone (not the least well-off) better off without making anyone else worse-off.

Is this policy supported by (a) Pareto? (b) Utilitarian? (c) Rawls?

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2.2 Criticisms of Rawls's theory

- Removing all cultural knowledge will immobilize the negotiators.
- Absolute priority to liberty? Poor people might be willing to trade off some liberty for greater social or economic advantage.
- Maximin is the optimal outcome under very restrictive assumptions.
- Individuals extremely risk averse here
- All that is relevant is the welfare of the worst-off person, even if a policy is extremely detrimental to everyone else.

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Isoelastic social welfare function

- Between extremes (additive SWF and Rawlsian):

$$W = \frac{\sum_i^n (U_i)^{1-e}}{1-e}$$

where U_i is utility of individual i .

Social welfare depends on the inequality aversion parameter, e .
Greater value of e , means we are more averse to inequality.

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Isoelastic social welfare function

- For $e=0$, the additive isoelastic SWF takes the form of the additive utilitarian SWF.
- For $e=\infty$, it takes the form of the Rawlsian SWF.

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Isoelastic social welfare function

- Social marginal utility of transferring one euro to individual i :
- Between extremes (additive SWF and Rawlsian):
- $\beta_i = \partial W / \partial U_i = (U_i)^{-e}$
- How much more worth is a euro going to a poor person compared to a euro going to a rich person ?
- Valuation ratio of poor (P) to rich (R):

$$\beta_P / \beta_R = (Y_P / Y_R)^{-e} = (Y_R / Y_P)^e$$

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Isoelastic social welfare function

- Thus, if $e = 1$, and the rich person has twice the income of the poor person ($Y_R = 2Y_P$),

$$\beta_R / \beta_P = (Y_R / Y_P)^{-e} = (Y_P / 2Y_P)^{-1} = 1/2$$

i.e., transferring one euro to someone at double the living standard of another has a social value of only one-half that of the reference person.

If $e = 0$

$$\beta_R / \beta_P = (Y_R / Y_P)^{-e} = (Y_P / 2Y_P)^0 = 1$$

$e=0$ indicates no inequality aversion with β_i the same for all households (additive SWF).

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Isoelastic social welfare function

- At the other extreme, if $e = 5$, and the rich person has twice the income of the poor person ($Y_R = 2Y_P$),

$$\beta_P/\beta_R = (Y_P/Y_R)^{-e} = (2Y_P/Y_P)^{-e} = 2^{-5} = 1/32$$

i.e., a value of 5 approaches the Rawlsian “maxi-min” principle in which only the impact on the poorest counts (where 1 Euro is worth 32 times the value of 1 euro to someone with twice that income).

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2.3 Miller's analysis of social justice

- He argues that a general theory of justice is logically impossible.
- Social justice has three different elements:
 - Rights**, for example political liberty, equality before the law, health care.
 - Deserts**, i.e. the recognition of each person's actions and qualities (e.g. someone who works longer hours should receive more income)
 - Needs**, i.e. the prerequisites for fulfilling individual plans of life (someone who is incapable of work should not be allowed to starve).
- Each principle embodies a different kind of moral claim.
- Rights and deserts can be reconciled (a person should have the right to keep all his income if he has earned it legally)
- Rights and needs can be reconciled (a person should be entitled to health care if he is ill)
- Needs and deserts are not reconciled (I am rich and healthy and you are poor and sick).

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2.3 Miller's analysis of social justice

- The definition of social justice depends crucially on the type of society being discussed.
- Pure market economy: justice is defined in terms of rights and deserts
- Collectivist view: justice is defined as distribution according to need.
- So, Rawls fails to develop a general theory of social justice.

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3 Collectivist views

- Collectivist writers agree on the importance of equality.
- Resources are available for collective use, hence government action is favoured.
- But disagreement on whether socialist goals can be achieved within the market order.
- Some writers are in favour of a mixed economy that blends private enterprises and state intervention
- Marxists argue that capitalism is inherently unjust, socialism is possible only if the state controls the allocation and distribution of most resources.

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3 Collectivist views

- Socialist aims: liberty (including freedom of choice and economic security), equality, fraternity (cooperation and altruism)
- In Miller's terms, **rights** and **needs** are dominant, **deserts** play a smaller role

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3. Collectivist views

- Socialist criticism of the free market:
 - Pursuing individual advantage does not promote the general good
 - Some decisions with widespread effects are taken by a small elite, and others are left to the arbitrary distributional effects of market forces
 - The market is unjust because it distributes rewards that are unrelated to individual need or merit
 - The free market is not self-regulating (unemployment)
 - The market has not been able to abolish poverty or inequality (Example, we spend on battleships and not for schools)

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3.1 Democratic socialism

- Democratic socialism argues that government intervention has made it possible to harness the market system to socialist goals, hence their support for a mixed economy (the ills for society can be corrected within a broadly capitalistic framework)
 - Government has a large role in economic life
 - The ownership of modern corporations is diffuse and largely separate from the people who manage them

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3.2 Marxists

- The Marxist approach differs in three ways:
 1. Classical political economists (Smith, Ricardo) see the production of commodities independent of the society in question. Conventional economic theory can apply to USA, former Soviet Union, Sweden ≠ The dominant mode of production determines the economic, political and social structure of a society. Thus, capitalism leads to a particular and inequitable structure of social class and political power.
 2. Conventional economic theory sees individuals as selling their labour services freely in a more or less competitive market, the wage rate equals the marginal product of labour, capital receives its marginal product, no exploitation ≠ Exploitation of labour under capitalism, for most people the sale of their labour is their only means to subsistence. The relations of production are enforced through the institution of the labour market and the capitalist can extract surplus value from the labour he employs. Inherent inequality in the distribution of output. Class conflict.
 3. The role of government in a capitalist society is to protect capitalism. The ruling class has the economic power, the political power and power over ideas.

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3.2 The Marxist State

- Marxists share the socialist triad of liberty, equality and fraternity
 - Freedom includes substantial equality and economic security (no contrast as in the liberal view between equality and freedom)
 - Equality. The Marxist aim is not equality but meeting need. Then, differences in rewards should depend on effort or ability.
- The Marxist state has a primary role in production and allocation, as well as in distribution and redistribution. Public ownership of the means of production, wide-scale participation of workers in decisions affecting their lives.
- Libertarians define freedom as the absence of coercion, so the welfare state reduces freedom
- Socialists define freedom to include some guarantee of economic security, so the welfare state enhances freedom

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Policy implications

The different theories of society have very different views about:

- Private property
- Taxation
- Redistribution
- Public production

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Policy implications

The different theories of society have very different views about:

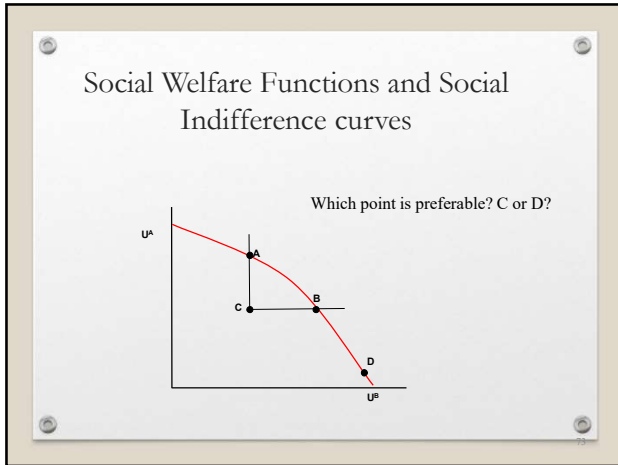
- Private property
- Taxation
- Redistribution
- Public production

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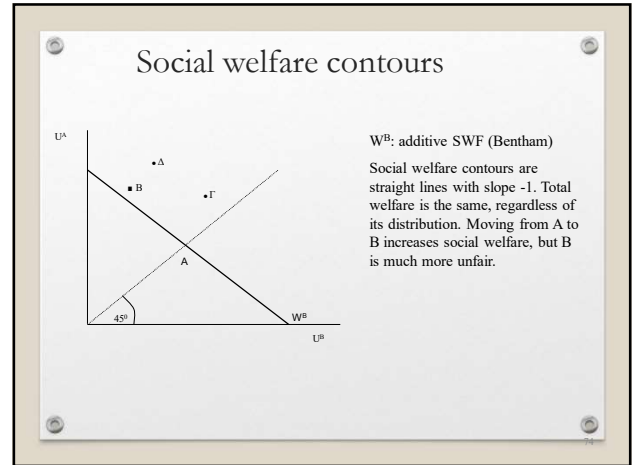
Attitudes towards the welfare state

- Natural-rights libertarians abhor the welfare state
- Empirical libertarians see a role for a highly parsimonious welfare state whose main purpose is poverty relief
- Liberals and democratic socialists regard the welfare state for the most part as beneficial
- Marxists are ambivalent
 - Is the welfare state a victory for the workers?
 - Or is its main function to protect the capitalist system (to reduce workers' hostility towards the capitalist regime)?

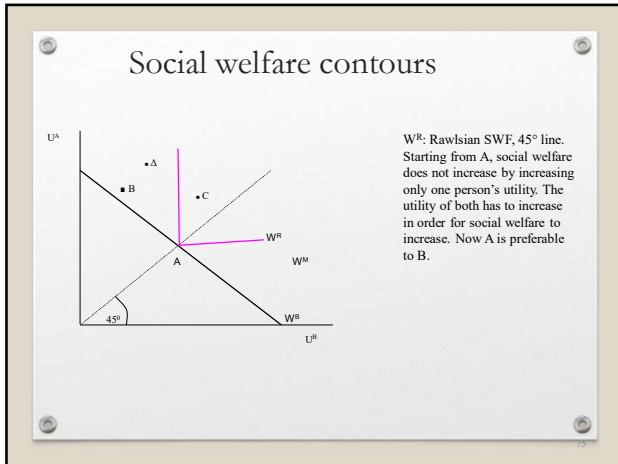
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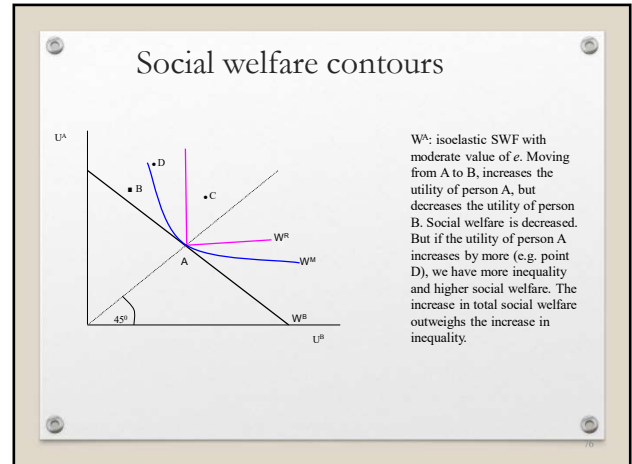
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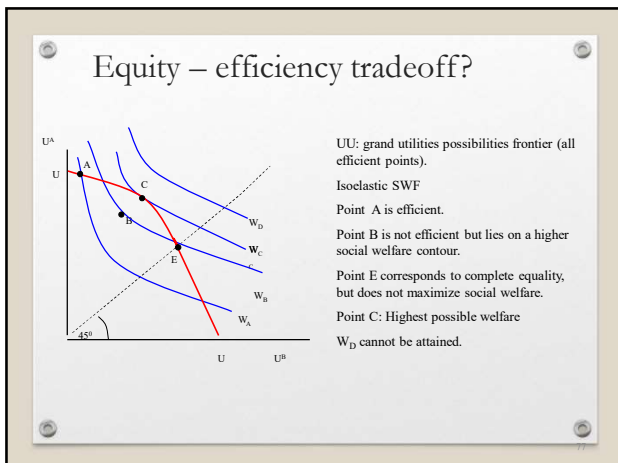
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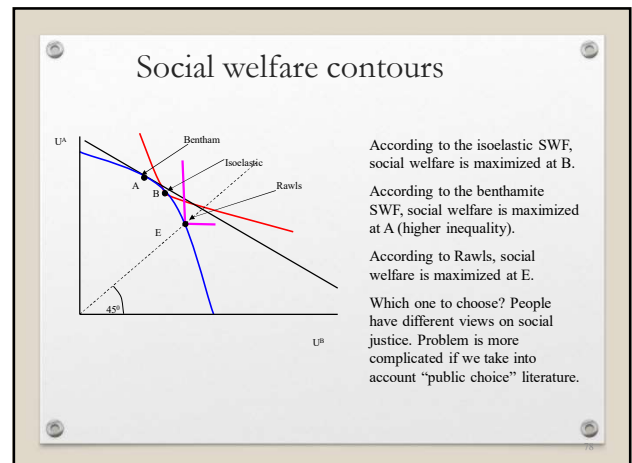
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A special case: Pareto Efficient Income Redistribution

- Suppose that utility of richer person does depend on poorer person's utility. That is:

$$U_{PETER} = U(I_{PETER}, U(I_{PAUL}))$$

- Government redistribution in this case could improve efficiency. It may be difficult for the private market to do this, if, for example, the rich lack information on just who really is poor.
- Simply an externality problem.

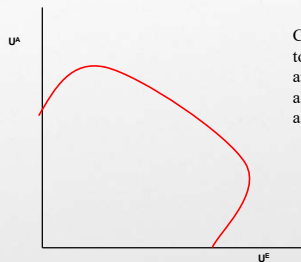
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A special case: Pareto Efficient Income Redistribution

- Altruism plays a role in this example, but private market could conceivably give charity.
- But not just altruism. Self-interest could play a role. Suppose there is a possibility that, for circumstances beyond your control, you become poor.
 - When well-off, pay "premiums." When bad times hit, collect "payoff."
 - Motivation of some social insurance programs.

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Efficiency and Social Justice



Can greater equality lead to increased efficiency and a Pareto superior allocation? The case of altruism

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Non individualistic views

- In previous cases, social welfare derived from individual's utilities.
- Some specify what the income distribution should look like independent of individual preferences.
- One example: *commodity egalitarianism*.
 - Right to vote, food, shelter, education, perhaps health insurance.

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Welfare Economics in economists' practice

Attitude of economists today towards welfare economics

- Strange contradiction:
 - There are very few papers explicitly on welfare economics and little theoretical discussion on welfare criteria.
 - **BUT**
 - Economists make welfare statements all the time (Citations from papers published in the Economic Journal), e.g. "The optimal policy is...", "In this article, we examine the welfare consequences of ...", "This change would increase social welfare."
 - There is public demand for such normative statements (central issues of public policy involve the setting of targets and the use of welfare criteria to judge progress, e.g. World Bank)
 - At the EU level, the 2000 Lisbon Agenda identified as the EU primary goals: growth, employment and *social inclusion*. Sustainable development (environment) was added in June 2001.

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Indicators used to assess the performance of the EU

1 GDP per capita	Growth
2 Labour productivity	Growth
3 Employment rate 15-64	Employment
4 Employment rate of older workers 55-64	Employment
5 Youth educational attainment	Social inclusion
6 R&D spending, % GDP	
7 Comparative price levels	
8 Investment spending, % GDP	
9 At risk of poverty rate after social transfers	Social inclusion
10 Long-term unemployment rate	Social inclusion
11 Regional cohesion	Social inclusion
12 Greenhouse gas emissions	Sustainability
13 Energy consumption	Sustainability
14 Inland freight volume	Sustainability

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Welfare judgments economists do...

- “The optimal policy is...”
- “In this article, we examine the welfare consequences of ...”
- “This change would increase social welfare.”

What is the underlying justification?

There are three ways to interpret what economists do

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1. Models of representative agents

- Identical households assume away differences in all relevant economic interests.
 - Changes in social welfare can be judged according to whether the “representative household” is better or worse off.
 - But, even if everybody is identical, social judgments might go beyond what enters individual utility, e.g. “merit goods”.

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1. Models of representative agents

- In a framework of strictly individualistic welfare, there are conflicting interests.
 - A modern economy is populated by consumers, workers, pensioners, owners, managers, investors, entrepreneurs, bankers, etc. In real world policy decisions is it safe to assume that everybody has the same interests?
 - Maybe sufficient to model macroeconomic behaviour (even this has been challenged by Solow, 2008, J. Ec. Persp).
 - But, rules out welfare economic problems.
 - How can you discuss desirability of reforms in the labour market or about pensions, without recognising that interests of workers in established jobs and those who are outsiders are conflicting, or that different generations have conflicting interests?

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1. Models of representative agents

- What about the fact that we are born at different dates? All members of a birth cohort may be identical, but their consumption will inevitably occur, at least in part, at different dates from that of their parents.
- Answer: Dynastic utility function, calculates the sum of future discounted utility for infinitely-lived dynasties (Lucas). Those present today take into account the interests of succeeding generations.
- But, a non-economist may ask: *Whose* dynastic welfare function? Are we saying to 50-year-olds that their welfare is judged by their 75-year-old parents? Or the reverse?

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1. Models of representative agents

- The current dynasty might apply a high rate of discount.
 - Lucas (1987) used 5% → utility from consumption in 2025 is valued under half today's utility.
 - Stern Report on Climate Change (2007) used 0.5% → utility from consumption in 2025 is valued almost as much as today's utility (92%).
 - Ramsey (1928) on optimal savings, any discounting is “ethically indefensible”.

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2. Utilitarianism

- There are differences between people (rich, poor, workers, landlords, etc.), but there is agreement on the welfare criterion to be applied.
- Presidential Address of Lucas to the AEA (2003)
 “To evaluate the effects of policy change on many different consumers, we can calculate welfare gains (perhaps losses, for some) for all of them, one at a time, and add the needed compensations to obtain the welfare gain for the group.”

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2. Objections to Utilitarianism

- The sum of utilities takes no account of how utilities are distributed.
 - Sen (1973) “maximizing the sum of individual utilities is supremely unconcerned with the interpersonal distribution of that sum”.
- Bergson-Samuelson individualistic social welfare function: $W(U_1, U_2, U_3, \dots)$
- Moral philosophy has moved beyond utilitarianism.
 - There is plurality and diversity in the welfare criteria that could be applied.
 - Plurality: A single person may bear more than one set of welfare criteria, e.g. greatest happiness and personal liberty.
 - Diversity: Different people hold different set of values. One person might be concerned with liberty, another with social justice. No sense to talk about “welfare consequences”. We have to apply multiple criteria.

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2. Theories beyond Utilitarianism

- Rawls (1972) Theory of Justice: inequalities in a society should work to the greatest benefit of the least advantaged (limiting case of giving more weight to those less well-off in the Bergson-Samuelson SWF)
- Sen (1985) Concept of capabilities: freedom that people have to function in key dimensions.

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2. Theories beyond Utilitarianism

- Sen’s (1985) central idea is that we have to look at what people are able to be, or do (rather than the means they possess).
- A person’s achieved living can be seen as a combination of ‘functionings’ (i.e. doings and beings), constituting the quality of life.
- Functionings include things like being alive, being well nourished and in good health, moving about freely, having self respect and respect for others, taking part in the life of the community, etc.
- The ‘capability set’ stands for the actual freedom of choice a person has over alternative lives that she can lead.
- Thus, individual claims are to be assessed not only by incomes, or utilities one enjoys, but in terms of freedoms one actually has to choose between different ways of living one has reason to value.

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2. Theories beyond Utilitarianism

- Two policy questions arise:
 - How do conclusions on the welfare consequences of a public policy change if Bentham is replaced by Rawls or Sen?
 - If people disagree on the desirability of a policy reform, could they be motivated by a different view of the objectives of society?

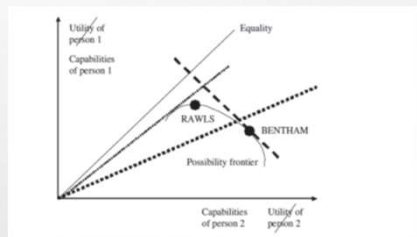
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3. Pareto dominance

- Seek to identify situations of dominance. Conclusions do not change with changes in the welfare criteria. Welfare statements are limited to changes that everybody better off or at least no one worse off.
- Its problems have been already discussed before.

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Conclusion: a diagrammatic representation of the issues



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