

## What is Welfare Economics?

Welfare economics is a branch of economics that uses microeconomic techniques to evaluate well-being (welfare) at the aggregate (economy-wide) level.

Prof. Baumol writes, “Welfare Economics has concerned itself mostly with policy issues which arise out of the allocation of resources, with the distribution of inputs among the various commodities and the distribution of commodities among various consumers.” And it may be emphasised again that allocation of resources is efficient or optimum when social welfare is maximum.

Welfare economics is the study of how the allocation of resources and goods affects [social welfare](#).

This relates directly to the study of economic efficiency and income distribution, as well as how these two factors affect the overall well-being of people in the economy.

In practical terms, welfare economists seek to provide tools to guide public policy to achieve beneficial social and economic outcomes for all of society.

However, welfare economics is a subjective study that depends heavily on chosen assumptions regarding how welfare can be defined, measured, and compared for individuals and society as a whole.

- ❖ Welfare economics is the study of how the structure of markets and the allocation of economic goods and resources determines the overall well-being of society.
- ❖ Welfare economics seeks to evaluate the costs and benefits of changes to the economy and guide public policy toward increasing the total good of society, using tools such as cost-benefit analysis and social welfare functions.
- ❖ Welfare economics depends heavily on assumptions regarding the measurability and comparability of human welfare across individuals, and the value of other ethical and philosophical ideas about well-being.

Welfare economics refers to the allocation of goods and resources for promoting social welfare. It deals with an economically efficient distribution of resources for the well-being of the people. Welfare economists seek to guide the public policy such that the distribution is economically and socially beneficial for all sections of the society.

Attempting to apply the principles of welfare economics gives rise to:

- ❖ Gives rise to the field of public economics, the study of how government might intervene to improve social welfare.
- ❖ Welfare economics also provides the theoretical foundations for particular instruments of public economics, including cost–benefit analysis, while
- ❖ the combination of welfare economics and insights from behavioral economics has led to the creation of a new subfield, behavioral welfare economics.

## Understanding Welfare Economics

Welfare economics begins with the application of utility theory in microeconomics. Utility refers to the perceived value associated with a particular good or service. In mainstream microeconomic theory, individuals seek to maximize their utility through their actions and consumption choices, and the interactions of buyers and sellers through the laws of supply and demand in competitive markets yield consumer and producer surplus.

Microeconomic comparison of consumer and producer surplus in markets under different market structures and conditions constitutes a basic version of welfare economics. The simplest version of welfare economics can be thought of as asking, "Which market structures and arrangements of economic resources across individuals and productive processes will maximize the sum total utility received by all individuals or will maximize the total of consumer and producer surplus across all markets?" Welfare economics seeks the economic state that will create the highest overall level of social satisfaction among its members.

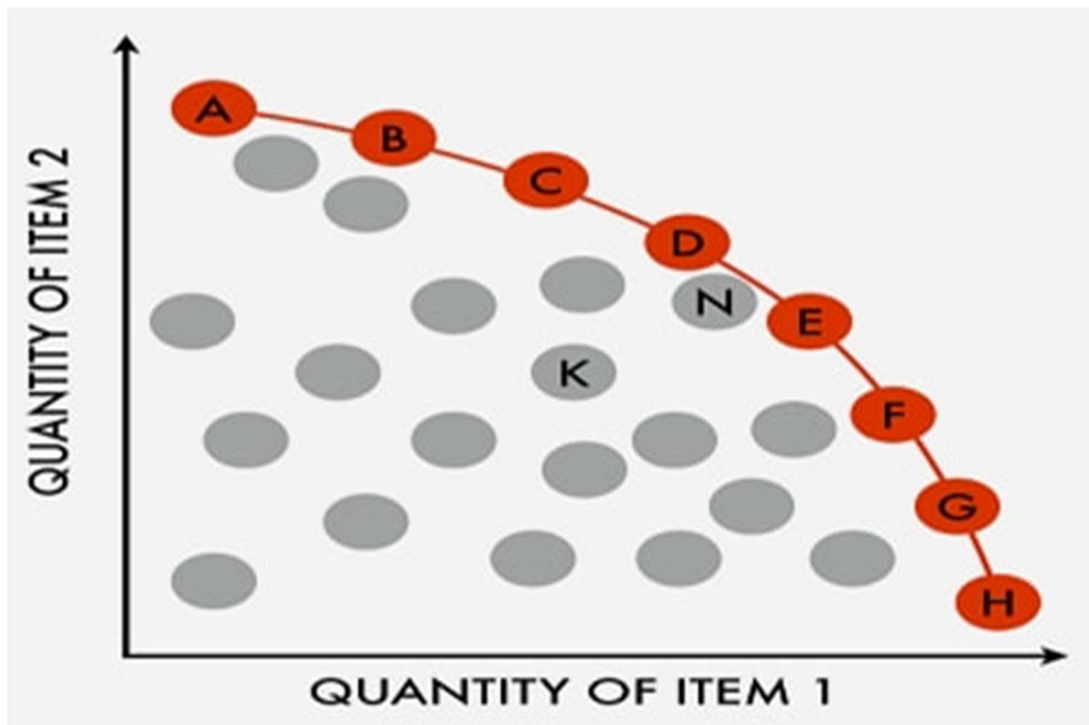
### ❖ Pareto Efficiency

Pareto efficiency (or Pareto optimality) is a quality of allocations in economics and game theory. If an allocation is Pareto efficient, no option can be made better off without making at least one other option worse off. The concept is named after Vilfredo Pareto (1848–1923), Italian engineer and economist, who used the concept in his studies of economic efficiency and income distribution. The concept has been applied in academic fields such as economics, engineering, and the life sciences.

The microeconomic analysis leads to the condition of Pareto efficiency as an ideal in welfare economics. When the economy is in a state of Pareto efficiency, social welfare is maximized in the sense that no resources can be reallocated to make one individual better off without making at least one individual worse off. One goal of economic policy could be to try to move the economy toward a Pareto efficient state.

According to Pareto criterion of optimality or efficiency, any change that makes at least one individual better off without making any other worse off is an improvement in social welfare. Of course, when a certain change makes everyone in the society better off, social welfare will undoubtedly increase. On the other hand, social welfare will decrease if a certain change makes no individual better off while it makes at least one individual worse off. With the aid of this criterion we can define the state of maximum social welfare or what is known as Pareto optimality or economic efficiency.

There is typically more than one Pareto efficient allocation. The set of all Pareto efficient allocations is called the Pareto frontier, Pareto front or Pareto set. The following image shows several Pareto efficient options as red dots; Grey dots are not Pareto efficient:

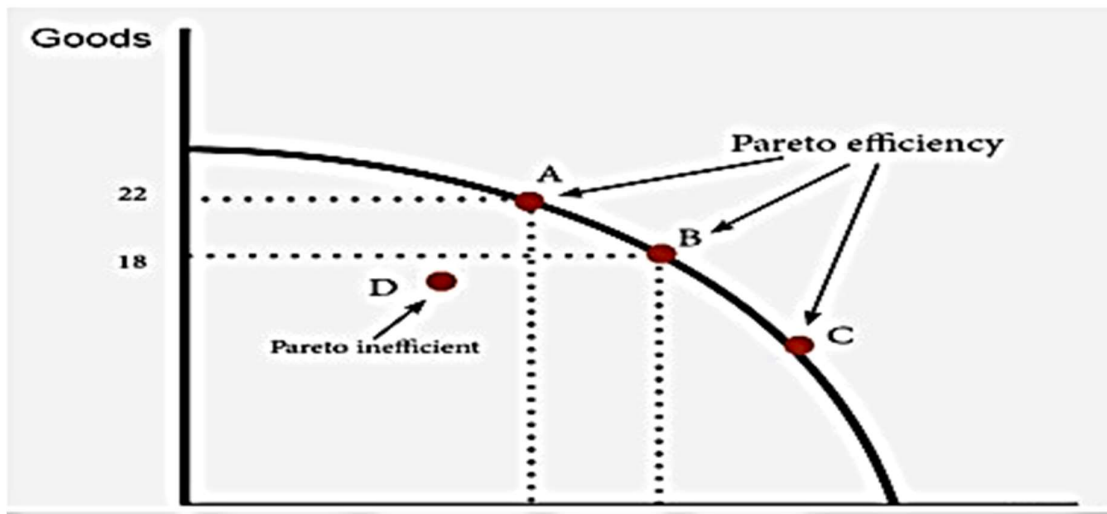


A Pareto improvement occurs when a change in allocation harms no one and helps at least one person, given an initial allocation of goods for a set of persons. The theory suggests that Pareto improvements will keep enhancing value to an economy until it achieves a Pareto equilibrium, where no more Pareto improvements can be made.

A Pareto improvement is said to occur when at least one individual becomes better off without anyone becoming worse off.

Pareto efficiency will occur on a production possibility frontier. When an economy is operating on a simple production possibility frontier, (e.g. at point

A, B or C) it is not possible to increase an output of goods without reducing an output of services



To evaluate whether a proposed change to market conditions or public policy will move the economy toward Pareto efficiency, economists have developed various criteria, which estimate whether the welfare gains of a change to the economy outweigh the losses. These include the Hicks criterion, the Kaldor criterion, the Scitovsky criterion (also known as Kaldor-Hicks criterion), and the Buchanan unanimity principle. In general, this kind of cost-benefit analysis assumes that utility gains and losses can be expressed in money terms. It also either treats issues of equity (such as human rights, private property, justice, and fairness) as outside the question entirely or assumes that the status quo represents some kind of ideal on these types of issues.

#### ❖ Social Welfare Maximization

However, Pareto efficiency does not provide a unique solution to how the economy should be arranged. Multiple Pareto efficient arrangements of the distributions of wealth, income, and production are possible.

Moving the economy toward Pareto efficiency might be an overall improvement in social welfare, but it does not provide a specific target as to which arrangement of economic resources across individuals and markets will actually maximize social welfare.

To do this, welfare economists have devised various types of social welfare functions. Maximizing the value of these functions then becomes the goal of welfare economic analysis of markets and public policy.

Results from this type of social welfare analysis depend heavily on assumptions regarding whether and how utility can be added or compared between individuals, as well as philosophical and ethical assumptions about

the value to place on different individuals' well-being. These allow the introduction of ideas about fairness, justice, and rights to be incorporated into the analysis of social welfare, but render the exercise of welfare economics an inherently subjective and possibly contentious field.

## **How Is Economic Welfare Determined?**

Under the lens of Pareto efficiency, optimal welfare, or utility, is achieved when the market is allowed to reach an equilibrium price for a given good or service—it's at this point that consumer and producer surpluses are maximized.

However, the aim of most modern welfare economists is to apply notions of justice, rights, and equality to the machinations of the market. In that sense, markets that are “efficient” do not necessarily achieve the greatest social good.

One reason for that disconnect: the relative utility of different individuals and producers when assessing an optimal outcome. Welfare economists could theoretically argue, for example, in favor of a higher minimum wage—even if doing so reduces producer surplus—if they believe the economic loss to employers would be felt less acutely than the increased utility experienced by low-wage workers.

Practitioners of normative economics, which is based on value judgments, may also try to measure the desirability of “public goods” that consumers don't pay for on the open market.

Measuring the social utility of various outcomes is an inherently imprecise undertaking, which has long been a criticism of welfare economics. However, economists have a number of tools at their disposal to gauge individuals' preferences for certain public goods.

They may conduct surveys, for example, asking how much consumers would be willing to spend on a new highway project. And as the economist Per-Olov Johansson points out, researchers could estimate the value of, say, a public park by analyzing the costs people are willing to incur in order to visit it.

Another example of applied welfare economics is the use of cost-benefit analyses to determine the social impact of specific projects. In the case of a city planning commission that's trying to evaluate the creation of a new sports arena, the commissioners would likely balance the benefits to fans and team owners with that of businesses or homeowners displaced by new infrastructure.

## Criticism of Welfare Economics

In order for economists to arrive at a set of policies or economic conditions that maximize social utility, they have to engage in interpersonal utility comparisons. To draw on a previous example, one would have to deduce that minimum wage laws would help low-skill workers more than they would hurt employers (and, potentially, certain workers who might lose their jobs).

Detractors of welfare economics contend that making such comparisons in any accurate way is an impractical goal. It's possible to understand the relative impact on utility of, for example, changes in prices for the individual. But, beginning in the 1930s, British economist Lionel Robbins argued that comparing the value that different consumers place on a set of goods is less practical. Robbins also disparaged the lack of objective units of measurements to compare utility among different market participants.

Perhaps the most potent attack on welfare economics came from Kenneth Arrow, who in the early 1950s introduced the “Impossibility Theorem,” which suggests that deducing social preferences by aggregating individual rankings is inherently flawed. Rarely are all the conditions present that would enable one to arrive at a true social ordering of available outcomes.

If, for instance, you have three people and they're asked to rank different possible outcomes—X, Y, and Z—you might get these three orderings:

1. Y, Z, X
2. X, Y, Z
3. Z, X, Y

You might conclude that the group prefers X over Y because two people ranked the former over the latter. Along the same lines, one can conclude that the group prefers Y to Z, since two of the participants put them in that order. But if we therefore expect X to be ranked above Z, we would be wrong—in fact, the majority of subjects put Z ahead of X. Therefore, the social ordering that was sought is not attained—we're simply stuck in a cycle of preferences.

Such attacks dealt a serious blow to welfare economics, which has waned in popularity since its heyday in the mid-20th century. However, it continues to draw adherents who believe—despite these difficulties—that economics is, in the words of John Maynard Keynes “a moral science.”

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