How can a policy-maker determine and achieve the optimal distribution of resources when lump-sum taxation is possible? What can be done when it is not?

Introduction

What is an optimal distribution?

- Explain Pareto-efficiency and explain downsides of not taking into account inequality
- Social welfare function:
    o They help decide between Pareto-efficient allocations to choose a point on the utility possibility frontier
    o Introduce different options: utilitarian, Rawlsian, inequality-averse
    o How does one choose between these: voting? But that has its own problems.

Lump-sum versus goods taxation

- Lump-sum:
    o State first and second Fundamental Welfare Theorem
    o By second Fundamental Welfare Theorem, there exist prices with which to reach the "optimal" allocation:
        ▪ First find the optimal allocations using the utility possibility frontier and social welfare function
        ▪ From this, you can find the set of prices by drawing the budget line
        ▪ Redistribute through lump-sum taxation to a point on the budget line
        ▪ Let markets operate freely
- Show how goods-taxation is less efficient than lump-sum-taxation:
    o Show with the diagram from the slides that the consumer is on a higher indifference curve with lump-sum taxation with the same government revenue.

When is lump-sum not available

- General issues around taxes not being popular/lobbying against them.
- The policymaker might not have full information on everyone's preferences
- Is there really perfect competition? Absence of externalities? And are preferences really convex?
- It is not really possible when taxes depend on behaviour: e.g., income, labor, consumption. These will alter prices moving society into the utility possibility frontier.

Conclusion