Chapter 5

Assessment of Neoclassical Welfare Economics

This seems an appropriate place to assess how far the theories presented in the first four chapters provide a useful guide to economic policy. The Paretian conditions described in Chapter 1 yielded some criteria for welfare judgements, even though their basis is rather narrow; they can be extended using a compensation principle, but this involves substantial distributional judgements. An even greater drawback in practice is the lack of guidance provided by Pareto's theory for the second-best situation, which forms the background for most economic decisions. These considerations do not create an encouraging impression for theorist or practitioner in the field of welfare economics, and it may be helpful to try and assess the arguments in a wider context.

First there is the question of how far efficiency alone should be the guide for policy decisions. Most citizens would agree that there are many other criteria for the welfare of the community which should bear at least some emphasis. The most obvious is that the way in which the economic 'cake' is distributed is almost as important as the total size of the cake (it is the latter which Paretian conditions seek to maximise). However, the exact emphasis to be placed on distribution and size is a matter of political debate, and even if some mutually
agreeable balance between these factors, and all the others which affect economic welfare, could be achieved, we cannot at present analyse them comprehensively to yield useful policy guidelines (though, as Chapter 8 shows, cost–benefit analysis is one development in this direction). This may seem a very negative argument for returning to the consideration of efficiency criteria alone, but when faced with the choice between using what he knows to be an inefficient and incomplete instrument, and abandoning the problem because of its complexity, the economist may reluctantly follow the former course, albeit aware of the limitations inherent in the analysis. Hence despite recognition that it is not the only, or even necessarily the most important, factor in social welfare, economists continue to concentrate on the maximisation of economic efficiency.

The obvious place to start such a study is to look at the best position which can be reached (and this is what Pareto did), establishing conditions which defined the position of greatest efficiency. Some of these need re-interpretation in particular circumstances where the definition of the appropriate marginal rate is unclear, but apart from one or two theoretical anomalies they provide unambiguous criteria to judge efficiency. Problems in using them arise when the change under discussion does not obey Pareto’s strict rules for improved welfare, and when constraints on the economy prevent the first-best position from being attained. It is the converse of the clear conditions for maximum welfare which Pareto provides that they are not applicable in part, and in these situations provide no guideline at all as to the optimum policy. It is interesting to note that many members of the public seem unaware of the limitations of Pareto’s conditions. They have a vague idea that competition is a ‘good thing’ because they recollect that it can sometimes lead to maximum efficiency, and this may even suggest to them that free enterprise should therefore be supported in all forms so that the economy can ‘automatically’ adjust to an optimum position. Right-wing politicians are notoriously prone to believe this fallacy. It is worth emphasising at this stage that although there are circumstances in which this argument holds it will not do so on Pareton grounds if either:

(a) there is not perfect competition in the industries concerned, for profit maximisation will not result in the establishment of Pareto marginal conditions; or

(b) these marginal conditions do not hold at all other points in the economy, for in this case a first-best position is unattainable and Pareto’s criteria are irrelevant.