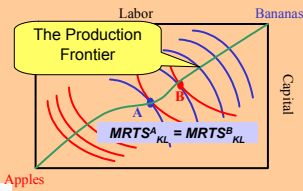


More Welfare Economics



Some Basic Assumptions

- A simple economy: Harry and Sally.
- There are two factors of production, capital, K, and labor, L.

$$L = L_H + L_S$$

- These two factors of production can be used to produce either apples or bananas.

Three Basic Questions

1. How many apples and how many bananas should be produced?
2. How should the apples and bananas be allocated between Harry and Sally?
3. How should capital and labor be allocated to the production of apples and bananas?

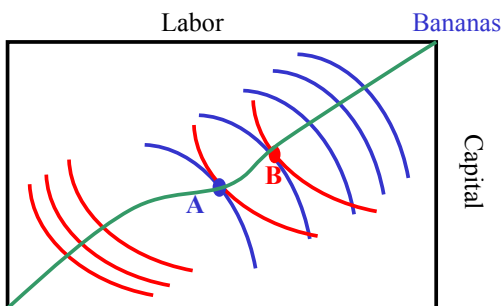
What We Have Seen

- Markets get us Pareto Optimality in Distribution.

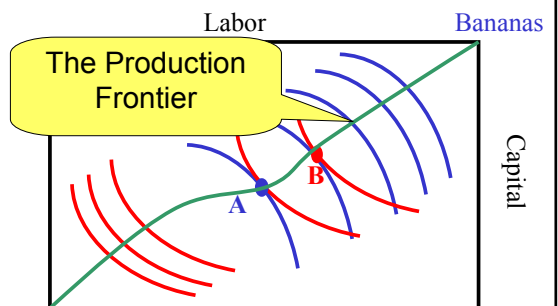
$$MRS(\text{Harry}) = MRS(\text{Sally})$$

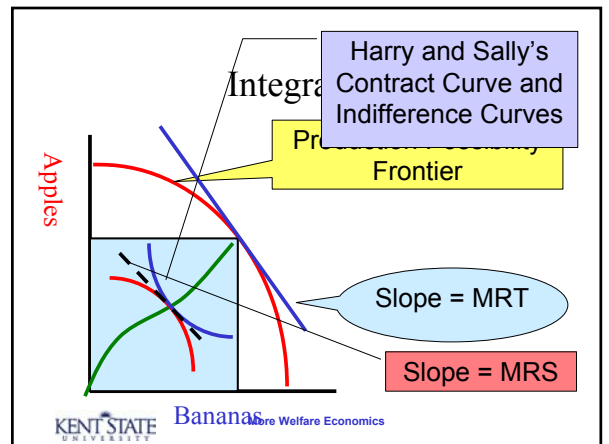
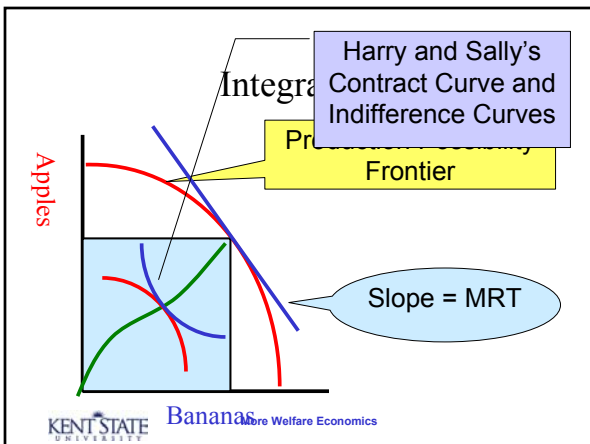
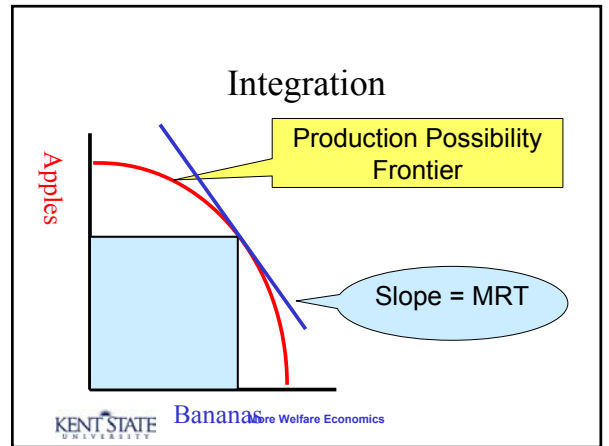
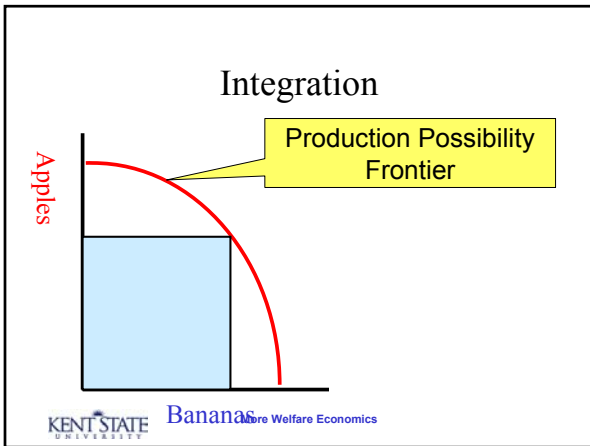
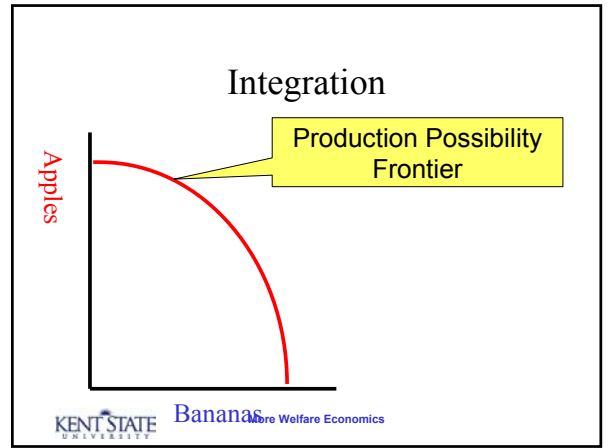
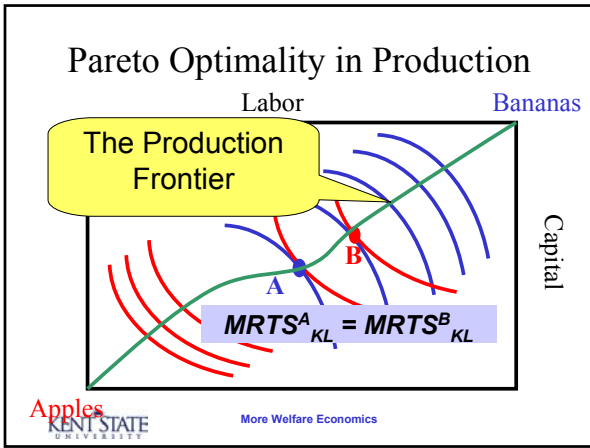
- There is more to the story.

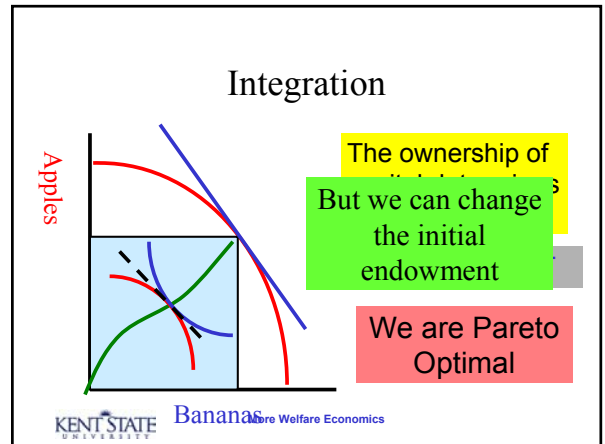
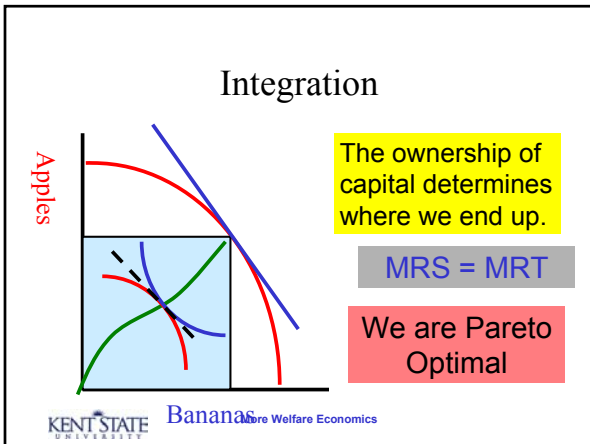
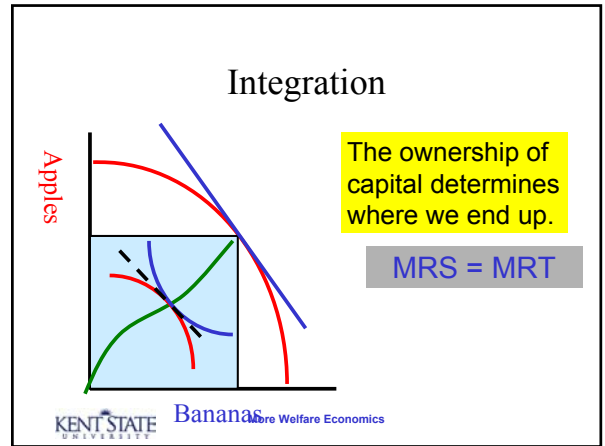
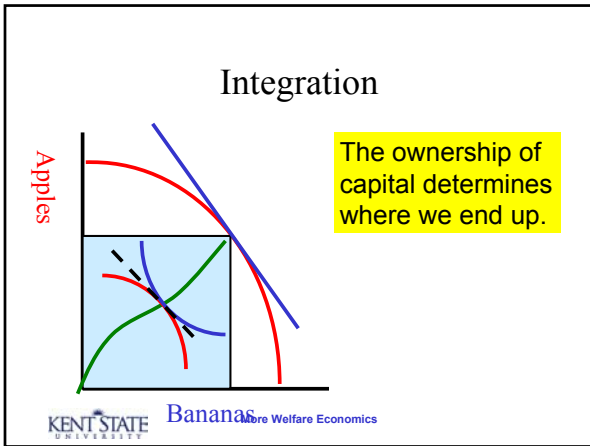
Pareto Optimality in Production



Pareto Optimality in Production







Summing Up

- This is the basic proof of the efficiency of the free market.

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Summing Up

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- MRS = MRT. We are Pareto Optimal..

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Summing Up

- This is the basic proof of the efficiency of the free market.
- The primary objection people raise is about the resulting distribution of income.

Income Distribution

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- The primary objection people raise is about the resulting distribution of income.
 - How can the market be so good if a very wealthy person can feed his dogs filet minion while others are struggling to live on dog food?
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Income Distribution

- The primary objection people raise is about the resulting distribution of income.
 - How can the market be so good if a very wealthy person can feed his dogs filet minion while others are struggling to live on dog food?
- If we take filet from the wealthy, depriving their dogs, to give to the poor, we are making one person better off and another worse off.
- We cannot make one person better off without making another worse off.

Summing Up

- The final distribution of apples and bananas between Harry and Sally is ultimately determined by who owns the capital and labor.

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- The final distribution of apples and bananas between Harry and Sally is ultimately determined by who owns the capital and labor.
 - If you think Harry is getting too much at the expense of Sally, economists argue you ought to redistribute income by redistributing the ownership of capital from Harry to Sally.

Summing Up

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- The final distribution of apples and bananas between Harry and Sally is ultimately determined by who owns the capital and labor.
- Efforts to interfere with markets lead to inefficiency. We end up inside the production possibility curve.
 - Most distribution schemes involve income taxes
 - If I must pay a tax of (say) 50% of my salary, then my incentives to work are reduced.

End

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