History of Economic Thought

Course ECO 423

Chapter 7: The institutionalist school, welfare economics and new classicism

Economic thinkers

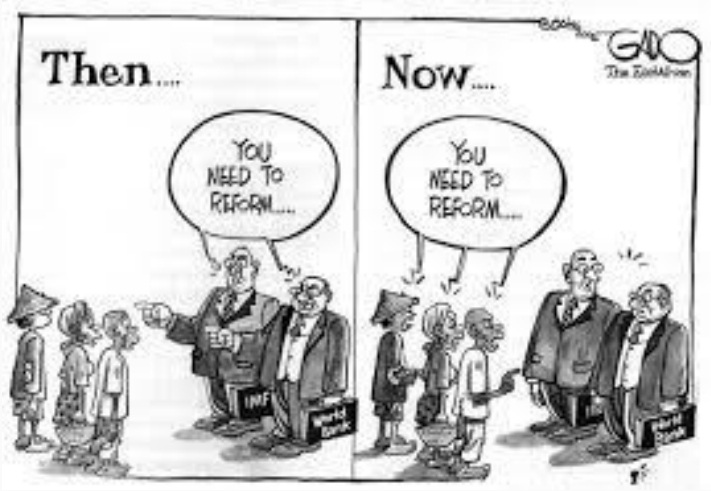
Vilfredo Pareto

Kenneth Arrow

Amartya Sen

Thorstein Veblen

Milton Friedman



Welfare Economics

- Welfare economics is a branch of economics that focuses on principles for maximizing social well-being.
- While not a unified theory, it deals with defining welfare optimality, exploring how it can be achieved, and identifying obstacles to well-being.
- Economists in this field analyze the use of limited resources to enhance societal satisfaction and propose ways to overcome barriers to maximum welfare.

Vilfredo Pareto

Kenneth Arrow

Amartya Sen

Vilfredo Pareto

Maximum welfare, said Pareto, occurs where there are no longer any changes that will make someone better off while making no one worse off. This implies that society cannot rearrange the allocation of resources or the distribution of goods and services in such a way that it aids someone without harming someone else.

The Pareto optimum thus implies:

(1) an optimal distribution of goods among consumers,

(2) an optimal technical allocation of resources, and

(3) optimal quantities of outputs.

Suppose the existence of a simple economy containing two consumers (Smith and Green), two products (hamburger and potatoes), and two resources (labor and capital). The conditions for a Pareto optimum in this simple economy are those that would exist in a realistic economy having numerous consumers, goods, and resources.

Vilfredo Pareto

Optimal distribution of goods

Goal: Maximize consumer welfare through optimal distribution of goods. **Condition for Optimality:** Achieved when all consumers have **equal marginal rates of substitution (MRS)** between goods. Symbolically: **MRShpS = MRShpG**

Marginal Rate of Substitution (MRS): Measures how much of one good a consumer is willing to give up to gain an extra unit of another good.

Example: Smith's MRShp = 5 (values hamburger more, potatoes less) and Green's MRShp = 2 (values potatoes more, hamburger less)

Pareto Improvement: Possible when consumers trade goods according to their relative valuations, making both better off.
Adjustment Process:

- As trade occurs, Smith’s MRShp falls and Green’s MRShp rises.
- Exchange continues until **MRS values equalize**.

Pareto Optimal Distribution: Reached when no further trades can make one consumer better off without harming the other — that is, when **MRS is equal across individuals**.

Vilfredo Pareto

Optimal technical allocation of resources

- **Objective:** Achieve Pareto optimality in production by efficiently allocating labor and capital between goods.
- **Condition for Optimality:** Marginal Rate of Technical Substitution (MRTS) of labor for capital must be **equal across both goods**. Symbolically: **MRTSlkH = MRTSlkP**
- **MRTS (labor for capital):** Indicates how much capital can replace one unit of labor while keeping output constant.
- **Example Scenario:**
  - MRTS in hamburger production = 2 (2 units of capital for 1 unit of labor) and MRTS in potato production = 3 (3 units of capital for the single unit of labor)
  - Capital is more efficient in hamburger production; labor is more productive in potato production.
- **Pareto Improvement Opportunity:**
  - Shift capital toward hamburger production and labor toward potatoes. Increases total output without harming anyone.
- **Reallocation Ends When:**
  - MRTS becomes equal across goods.
  - Diminishing returns make further gains impossible without someone becoming worse off.
- **Conclusion: Optimal resource allocation** occurs when MRTS is equal across all production uses — ensuring no more beneficial reallocation is possible.

Vilfredo Pareto

Optimal quantities of output

Objective: Ensure the economy produces the optimal mix of goods to maximize social welfare.

Condition for Optimality: Marginal Rate of Substitution (MRS) between goods must equal the **Marginal Rate of Transformation (MRT)**. Symbolically: **MRShp = MRThp**

MRS (consumer side): The rate at which consumers are willing to trade potatoes for hamburger.
MRT (production side): The rate at which the economy can technically transform potatoes into hamburger.
Example Scenario: MRShp = 4 (give up 4 potatoes to consume 1 hamburger), MRThp = 3 (give up 3 potatoes to make 1 hamburger)→ **Consumers value hamburger more than it costs to produce it.**
Implication: Increase hamburger production, reduce potato output — this improves overall welfare.
Pareto Improvement Possibility: Exists if **MRS ≠ MRT** — output mix can still be adjusted to benefit someone without hurting others.
Efficiency Achieved When: MRS = MRT → No further welfare gains are possible from changing the output mix.

Kenneth Arrow

Impossibility Theorem

Purpose: To analyze if democratic voting can aggregate individual preferences into a consistent social choice that reflects those preferences fairly.

Arrow's Four Conditions for Social Choice:

1. **Transitivity:** Social preferences must be consistent (if A > B and B > C, then A > C).
2. **Non-dictatorship:** No single individual should dictate the group's choice.
3. **Pareto Efficiency:** Social choices should not contradict unanimous individual preferences.
4. **Independence of Irrelevant Alternatives:** Social preference between two options depends only on individuals' preferences between those two, unaffected by other alternatives.

Arrow's Key Finding: No majority voting system can satisfy all four conditions simultaneously for three or more options.
Broader Impact: Arrow's theorem challenges foundational assumptions in political and economic theory about collective decision-making and welfare maximization.

Kenneth Arrow

Impossibility Theorem

Illustrative Example:

- Three voters (1, 2, 3) choose among three policies: A (disarm), B (cold war), C (hot war).
- Individual preferences differ, but majority votes create **cyclical preferences**: A beats B, B beats C, yet C beats A, violating transitivity.

Implications:

- Majority voting can produce irrational and inconsistent social choices.
- Perfect democratic decision-making is impossible; compromises or second-best solutions are necessary.

Arrow's Paradox of Voting

POLICY	VOTER 1	VOTER 2	VOTER 3
A	1st choice	3rd choice	2nd choice
B	2nd choice	1st choice	3rd choice
C	3rd choice	2nd choice	1st choice

Table 20-2
Vote Outcomes

ELECTION	WINNER
A vs *B*	*A*
B vs *C*	*B*
A vs *C*	*C*

Amartya Sen

Social choice

Sen's Goal: To address the limitations of Arrow's impossibility theorem and improve the theory of collective choice.

Key Limitations in Arrow's Model Identified by Sen:

1. **Lack of Preference Intensity (Ordinal vs. Cardinal):** Arrow's model uses **ordinal preferences** (ranking), ignoring how **strongly** someone prefers one option over another. **Cardinal measures** (e.g., utility points) could capture this intensity but are hard to quantify and compare between individuals.
2. **Exclusion of Interpersonal Comparisons:** Arrow assumes that preferences cannot be compared across individuals due to lack of a common utility scale. Sen argues that **interpersonal comparisons** are essential and can be **meaningfully made**, especially in moral or social contexts.

Why Intensity Matters: In real-life decisions, someone who **strongly** prefers A over B should arguably have more "voting weight" than someone with a weak preference. Voting systems that allow people to **distribute points** to options could better reflect intensity and avoid paradoxes.

Role of Social Context in Preference Formation: Sen argues that individuals are influenced by their **social roles, class, and concern for others**, not just self-interest. Collective choices should reflect these **socially informed values**, not the isolated "economic man" model.

Example of Interpersonal Comparison: Asking whether someone would prefer to be an unemployed laborer in society X or a well-paid engineer in society Y illustrates meaningful comparison across people and situations.

Amartya Sen

Inequality

Critique of Pareto Optimality: Pareto optimality is a weak criterion—it allows for highly unequal distributions. In cases like dividing a cake, **any distribution is Pareto optimal**, making the concept **useless for addressing inequality**.

Sen's Broader Concern: Modern welfare economics' overreliance on Pareto optimality **fails to engage with real issues of inequality and fairness**.
Equality vs. Equity: Sen emphasizes **equity over pure equality**: distribution should reflect either **needs** or **desert** (i.e., fairness-based merit).
Two Rival Norms for Distribution:

1. **Needs-based:** A should get more because A needs more.
2. **Desert-based:** A should get more because A worked harder or contributed more.

Sen's Preference for Needs-Based Justice: Although needs involve **interpersonal utility comparisons** (often dismissed as unmeasurable), Sen defends them as morally and practically significant.

Amartya Sen

Inequality

Two Egalitarian Arguments:

1. **Probabilistic Egalitarianism:** Under uncertainty about individuals' utility functions, equal distribution **maximizes expected utility** due to diminishing marginal returns.
2. **Maximin Egalitarianism :** Under complete ignorance about people's needs, equal distribution **maximizes welfare** for the least well-off.

Sen's Cautions on Complete Equality: Full equality may not be optimal; however, **in the absence of precise knowledge**, equal distribution is a **rational default**.

Desert-Based Distribution: Four Approaches Critically Assessed:

1. **Incentives:** Rewards promote effort but must be justified beyond needs.
2. **Merit:** Problematic due to unfair initial advantages (e.g., luck, genetics).
3. **Marxist View:** Labor is exploited; yet even Marx favors **needs** over labor claims in a just system.
4. **Neoclassical Marginal Productivity:** Focuses on efficiency (Pareto optimality), but lacks normative depth about fairness or justice.

Sen's Conclusion: Needs-based distribution aligns more with human dignity and moral reasoning than market-based or meritocratic systems.

The Institutionalist School: major tenets

Holistic: Institutional economics views the economy as a whole, emphasizing that economic activity is shaped by social, political, and cultural factors, not just individual actions.

Role of institutions: Institutional economics emphasizes the role of institutions—customs, laws, beliefs, and social behaviors—in shaping economic life, focusing more on group behavior than individual actions and advocating reform and planning.

Evolutionary approach: Institutionalists use a Darwinian, evolutionary approach, focusing on how economic institutions change over time, emphasizing historical and social context over static economic laws.

Rejection of normal equilibrium: Institutionalists reject the idea of normal equilibrium, viewing economic maladjustments as normal and ongoing, requiring continuous government intervention to address issues like recessions, stagflation, and deficits.

Clashes of interest: Institutionalists highlight conflicts between group interests in society and stress the need for government to mediate these clashes for the common good and economic efficiency.

Liberal democratic reform: supported liberal reforms and a stronger government role to promote equity, rejecting laissez-faire and the belief that markets alone ensure fairness or efficiency.

Rejection of pleasure-pain psychology: rejected the traditional pleasure-pain basis of economics and instead incorporated Freudian and behaviorist psychology for a deeper understanding of economic behavior.

Thorstein Bunde Veblen

Leisure Class Characteristics: Engages in **conspicuous consumption**—wasteful spending to display wealth and status. Avoids useful work and maintains conservatism.

Purpose of Consumption:

- Wealth is shown off not for needs but to signal power, prestige, honor, and success.
- Consumption must appear wasteful to be reputable.

Influence on Society: Even poorer classes imitate conspicuous consumption, influenced by the leisure class.
Role of Women: Women display wealth through fashion and behaviors that signify leisure-class support, e.g., expensive clothes, delicate appearance, and avoidance of labor.
Examples of Conspicuous Consumption:

- Expensive items and activities that have little practical value but high status symbolism (e.g., patent-leather shoes, exotic flowers, deer over cows, yachts, luxury cars).
- Status symbols evolve as common luxury goods become widespread (e.g., from Porsches to Rolls Royces).

Veblen’s Critique: Status-driven consumption often lacks intrinsic beauty or utility, focusing instead on social signaling.

Thorstein Bunde Veblen

Veblen goods and upward sloping demand curve

Integration into Neoclassical Economics: Veblen's idea that some consumers buy luxury goods for status (conspicuous consumption) is incorporated into neoclassical utility theory.

Conspicuous Consumption Utility: Beyond intrinsic value, some goods (Veblen goods) provide utility tied to their high price and status display. Utility from a good depends on both its inherent qualities and the price paid. Higher price can increase conspicuous consumption utility.
Demand Curves Explanation: Conventional demand curves (D1, D2, D3) assume constant conspicuous consumption utility at each level. When price decreases, conspicuous consumption utility also decreases, shifting demand curves leftward.

Price Effects: Standard Price Effect: Lower price → higher quantity demanded (movement down the curve). **Veblen Effect:** Lower price → lower conspicuous consumption utility → shift demand curve left, reducing quantity demanded.

Net Effect on Demand: Sometimes the Veblen effect can outweigh the standard effect, causing a net decrease in quantity demanded when price falls. This can produce an **upward-sloping individual demand curve** for Veblen goods.

Thorstein Bunde Veblen

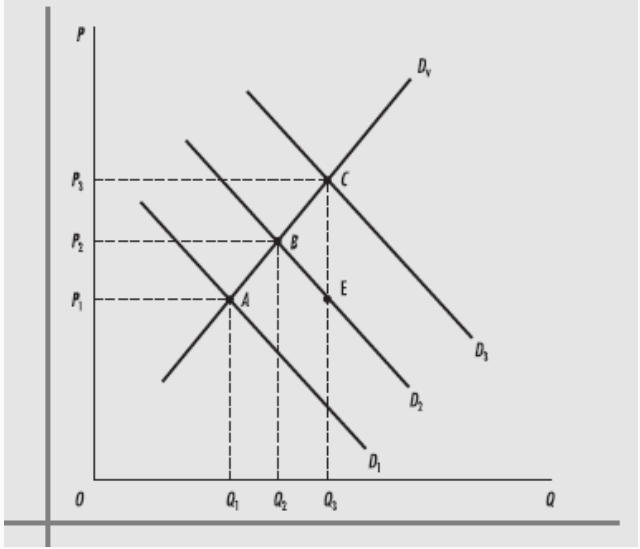
Veblen goods and upward sloping demand curve

Market Demand Reality:

- Despite some individuals showing upward-sloping demand, overall market demand for Veblen goods still slopes downward.
- New buyers enter as prices drop, increasing quantity demanded.

Significance:

- The concept helps understand why luxury goods may sometimes defy normal demand patterns due to status-related consumption.



Thorstein Bunde Veblen

Propensity to avoid useful work

- **Avoidance of Productive Work:**
  - Leisure class members deliberately avoid useful, productive labor.
  - Engage only in wasteful or non-productive activities to maintain social status.
- **Examples of Leisure-Class Occupations:**
  - Government, war, sports, and devout religious observances.
  - These are seen as predatory or symbolic rather than genuinely productive.
- **Motivation:** Gains are obtained through seizure, force, or conversion, not productive effort.
- **Presence of Force and Fraud:**
  - Force and deception exist in modern war, business, and sports, similar to barbaric times.
  - Strategy in these areas often involves cunning, chicane (deceptive trickery), and regulated forms of fraud.
- **Sports and Fraud:**
  - Sports habituate individuals to deceitful tactics, sharpening skills in cunning and overreaching opponents.
  - The prevalence of competitive sports reflects and fosters a predatory temperament in society.
- **Broader Implication:** The leisure class's lifestyle promotes and reflects a social environment tolerant of sharp practice and disregard for others' interests.

Thorstein Bunde Veblen

Conservatism

Social Evolution as Natural Selection: Social institutions evolve through natural selection of habits and adaptation to changing environments. **Conservatism** refers to the tendency of social institutions and habits of thought to resist change and persist over time, even when they no longer fit current economic or technological realities.

Cultural Lag: Conflict exists between **ceremonial (traditional) institutions** and **dynamic (technological) institutions** due to slow adaptation. Institutions are inherited from the past and often misaligned with present needs.

Social and Psychological Inertia: Habits, attitudes, and institutions tend to persist, causing **conservatism** and resistance to change. This inertia slows societal evolution.
Mental Adaptation Process: Society evolves as individuals adapt mentally to new circumstances, pressured by changing environments.
Sheltered Classes Retard Change: The wealthy leisure class, insulated from economic forces, adapts slowly and resists social change. Their attitude: “Whatever is, is right,” opposing the evolutionary view that current institutions are inadequate.

Evolutionary View of Institutions: Institutions are often **“wrong” or outdated** because they don’t change fast enough to meet current demands.

Thorstein Bunde Veblen

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The Chicago School: major tenets

Optimizing behaviour: People make rational, optimizing decisions to maximize well-being, seeking information until its cost equals its benefit, and responding to incentives.

Prices and wages: Prices and wages generally reflect long-run competitive values and opportunity costs; market forces and property rights help correct inefficiencies over time.

Mathematical orientation. The Chicago school relies heavily on mathematical theorizing (unlike the neo–Austrians, for example), using both the Marshallian partial equilibrium method and the Walrasian general equilibrium approach. Empirical verification is stressed but sometimes left to others.

Rejection of Keynesianism: Monetary policy drives economic stability; recessions stem from policy errors, not spending shifts. Inflation is purely a monetary phenomenon, and fiscal policy is ineffective without monetary support.

Limited Government: Government is inefficient, often serving officials' or special interests rather than the public, with regulation typically benefiting private actors who exploit it.

Milton Friedman

Demand for money: Friedman saw money demand as demand for cash balances, driven by permanent income and the costs of holding money—interest rates, inflation expectations, and price level—though it is generally interest inelastic.

Modern quantity theory of money: Friedman's modern quantity theory holds that money demand is stable and that excess money supply leads to increased spending, raising output and prices. In the long run, only prices rise, making inflation a result of rapid money growth. This money-price link is consistent across time and economies.

Long run vertical Phillips curve: Friedman’s long-run Phillips curve theory states that unemployment cannot be permanently reduced below its natural rate through inflation. Temporary reductions are possible only when inflation exceeds expectations. As people adjust their expectations, the short-run Phillips curve shifts upward, and unemployment returns to its natural rate. Thus, the long-run Phillips curve is vertical, showing no permanent trade-off between inflation and unemployment.

Monetary rule: Friedman’s monetary rule argues against discretionary monetary policy. Instead, he advocates a fixed, steady growth of the money supply aligned with the economy's long-run capacity. This prevents Fed-induced instability, reduces uncertainty from policy lags, builds public confidence, and shields monetary policy from political influence.