

# Different approaches to pareto principle economics essay



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Pigou mentions that Pareto measures the imbalance of distribution by dividing an algorithm of number of incomes in excess to any amount of  $x$  into algorithm of  $x$ . This measure is useful only if we accept the Pareto view that in all different income distributions, the ratio between the two algorithms is almost the same for all values of  $x$ . (A. C. Pigou, 1932) However, it is a matter of disagreement of the reciprocal of his measure which would indicate less equality when the men themselves indicate greater equality, is not preferred that matter (Rader, 1980). In Pareto's approach, morality, goodness, and justice could never have a descriptive content as they "designate nothing more than indistinct and incoherent sentiments." Even if Pareto had no time for cognitive relativism, he was an ethical relativist, who thought that "ought" statements lay beyond the reach of reason. (Femia, n. d.)

## **Pareto and income**

If one's well-being only depends on his material resources, then a Pareto efficient distribution should also be beneficial in a level of well-being. But a person's well-being is also influenced by other things like love and presents. Pareto efficiency on these two levels no longer coincides. (Hansson, 2004) Another disadvantage of Pareto law is the allowance of inefficiencies in consumption. The use of resources is the measure for utility maximization, but satisfaction includes resources that may imply a waste of resources through satisfaction of luxury desires, or resources unlike to resources like the song of a bird. (Staveren, 2006)

In addition, Pareto assumed that the income pyramid is the same in all societies. He also blinded by the timelessness and universality of

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mechanical regularities, and denied the existence of differences (J. H. Meisel, 1965)

## **Multiple solutions**

The fact that there can be multiple Pareto optimum situations decline the value of Pareto's law as tool for allocative decisions especially when these solutions are characterized from unfairness. For example a Pareto efficient solution could be the one in the bottom left corner of the box. But this solution is inequitable and may not find use and requires other criteria for judging optimality. The reason for this inefficiency is that the Pareto's law can rank alternative states; if between the stages exist only losers and gainers. Another drawback of Pareto principle is that it doesn't ensure a full ordering of stages, if the preference is indifferent between two stages then they should be judged as equally good. (Zeckhauser, 1973)

To determine a Pareto efficient situation is simple only quantitative parameters (Popa, 2007), but economics have to do with both quantitative and qualitative parameters. Unfortunately individuals' preferences cannot be considered only quantified. We should recognize that there is no way to determine how Pareto efficiency may brought about. There is no objective way to value what is an individual loss or gain because different individuals' utilities or preferences value differently the same gain or benefit (Popa, 2007)

Moreover even if we talk about monetary value, there always be some features that cannot be quantified. The marginal utility of different benefits decreases while while their available quantity raises. We can describe this

situation in ordinary terms by comparing the order of preferences without allocate them clearly specified values(Popa, 2007)

The value of Pareto Theorem is also questioned because of its assumptions. For example the symmetry of information is not feasible in the real complex world. Either assumptions about individuals preferences are rational. Neither economic agents treat their preferences as exogenous, well defined and stable nor they manage their preferences perfectly (Kaplow & Shavell, n. d.)

Pareto's law is formed as a criterion for exchange, with the assumption the agents maximize their utility through exchange, instead their production, gifts or redistribution. It is also taken for granted that the agents have almost equal bargaining power deriving from equal redistribution of endowments. Finally it hides the assumption that competition will eliminate the less efficient producers.(Staveren, 2006)

## **1st and 2nd theorem**

Pinakas me ta theorimata

As we have already mention the 1st and the 2nd theorem operates under very strict conditions. But there are cases in which the 1st can be applied and the second not. For instance as regards the competitive equilibrium with some non convexity sets individual firms or preferences of consumers (J. Hindricks, G. Mylnes 2006)

The second theorem has two main weaknesses Firstly it is based on the simplification of assumptions for perfect competition. It is not guaranteed that efficiency will be preserved while there are distortions. In addition it

ignores the distribution of resources. Another important issue is that it does not describe the mechanism of decentralization. It just determines the prices that make the chosen allocation equilibrium. This could be very unrealistic because of the lack of wealth redistribution (Jean Hindricks, Gareth Mylnes)

Moreover the use of 2nd theorem in policy needs the use of optimal taxes. These taxes however could not satisfy the required criteria and may have additional cost. The 1st theorem is not a sufficient condition of efficiency as it allows inefficiencies to occur and persist in production and allocation through presumably competitive market (Staveren, 2006) The 2nd theorem is useful in a theoretical base but with limited practical use.

## **Distribution allocation and Endowments**

Regarding the issue of distribution Pareto Efficiency is unable to distribute the common goods and any inept allocation will be perpetuated (Popa, 2007)

An other failure of Pareto efficiency is the allocation of scarce resources.

According to Pareto optimum any allocation that does not use all the available resources is inefficient. But as most of allocations comprise scarce resources what is requested is their redistribution. This question arises again the problem of criteria (Popa, 2007) Moreover the human nature characteristics like emotions and the sense of fairness often conflict with the Pareto law. (Kaplou, 2005)

## **Competition**

It is often argued that by definition is beneficial for economic agents to pass from a Pareto inefficient allocation to a Pareto optimum one. As discuss below this argument is plausible (Arrow, 1970) According to Bowels and

Gintis, efficiency is not the natural result of competition, as Pareto law claims. Pareto criterion ignores that competition depends on social and political influences, moral values and institutions. (Staveren, 2006). According to Robinson (1933) the difference between production and exchange is aggregate, in situation in which labor is not a rare production factor

In addition the Pareto principle cannot analyze the pressure felt by inefficient firms, when they do not use optimally the resources. The allocation between the firms will change because the exit-entry process. Pareto also ignores the external effect of innovation and knowledge diffusion through firms (Sengupta, 2012). Finally Pareto optimality does not lead always to socially desirable allocations. It is not guaranteed that the Pareto distributions will be equitable. An oligopoly can also be Pareto efficient, like a competitive can be. (Popa, 2007)

## **Pareto and international trade**

The Pareto efficiency criterion can not be applied in international financial transactions. For example the carbon prices should be the same across sectors within countries, or the permits tradable across them. But for equity reasons may it should be lower in countries judged less necessary. The tariffs could be useful for alleviate indirectly the underlying cross country equity reasons that can warrant different of that responding to distortions for differences in carbon prices.

## **Exchange**

An other criticism could be expressed about the procedure of exchange.

Voluntary exchange it is efficient as it allocates resources to those who

derive most utility for them, This assumption holds an interpersonal level and denies that a redistribution of resources may leads to a higher aggregate utility. Additionally it ignores that this procedure ma manipulates by the policy, the bargaining power etc.(Staveren, 2006)

## **Fairness and welfare**

As we have already point out a Pareto improvement does not always cause a necessarily welfare improvement.(Mongin, 2010)Whatever is the proposed social welfare function there always be some utilities functions witch conflicts with at least one of the conditions, thus it is not possible an ideal social welfare function (Zeckhauser, 1973) For example Pareto efficient is a standpoint, a rich who tries to increase his welfare than the welfare of non consenting poor decreases, would not cause a damage, but this loss would lead the poor to starvations (Sapienza, n. d.)

On the other hand according to the assumptions the information structure is given. But if a particular information structure can cause an incline of Pareto inefficiency than there is the transition of information for one gent to another. This creation of information has an economic value. Marshak has started to study the economics information but yet there are not any safe conclusions. (Arrow, 1970). Another inefficiency of Pareto rule id that it fails to analyze the efficiency between the firms in industry. This gap will increase over time as creative process of distraction and technology stimulate the development of efficient firms.(Sengupta, 2012b)

Externalities

In case of externalities competitive economy cannot achieve Pareto efficiency.. the private and social cost differ and the competitive equilibrium would not be efficient.(Geanakoplos & Polemarchakis, 2008) The individuals will act in their own self-interest, and they will not have the correct incentives to maximize. When externalities exist the government should take action to correct them. The governments' target should be to move the economy to a social optimal point as it presented in the figure above, (Zilberman, 1999) the social optimum can be achieved in several ways such as a set of lump taxes or encouragement of competition(Zeckhauser, 1973)

### Pollution and externalities

On the one hand Beckerman defend of Pareto criterion by arguing that sustainable development is against Pareto efficiency (Sapienza, n. d.)on the other hand Daly claims that Pareto efficiency ignores the relation of economic activity with carrying capacity of the environment. Another problem with neoclassical approach is the irreversibility typical economists have a wait and seen attitude, but when problems like animal extinction arise than you can not change the situation by changing your economic behavior. (Gowdy & Olsen, 1994) The application of Pareto optimality confrontation in pollution has the same problem with common goods. The pollution removal would benefit all the victims with no extra cost an the proble of free rider emerges (Lewin, n. d.).

### Common goods

According to Pareto law is not appropriate to supply society with common goods through private enterprise in the market. Even if it is technically  
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possible to set a price for their services, this would exclude some consumers from the use. But this use wouldn't harm anyone.

### Pareto policy

One weakness of Pareto principle is that social welfare function captures the distributive preferences of a central planner. There is a potential welfare inconsistency between this construction and the evaluation using planners preferences. For example what is true under preferences may not be under planner's (Staveren, 2006) Another issue is the possibility of multiple solution of same utility, denies the threshold effects. (Gowdy & Olsen, 1994)

When deviations from the optimum situation are not limited than the voluntary agreements are technically not possible and states intervention is necessary (J. G. Head, 1974)

The market function is not enough to achieve Pareto efficiency, so it is necessary the creation of an organization which provide the conditions for market to generate the desired outcome. However a lot of criticisms have expressed about the application of Pareto criterion in policy.

Firstly it is not possible to achieve the necessary unanimous agreement. This activity is also costly as it absorbs resources that otherwise could satisfy societies, undergo (" AK\_Backhaus\_1980. pdf," n. d.) Furthermore it is difficult to define where the borderline of government's interaction should be drawn. (Popa, 2007) the different political power of governing elite and economic elite as also the different distribution of wealth conflicts with the

assumptions of Pareto efficiency. (Femia, n. d.) Thus the prisoners' dilemma shows that the full application of Pareto law may reduce the rationale of state existence. ("AK\_Backhaus\_1981. pdf," n. d.)

### Voting systems

Thomas Schelling queries whether Pareto efficiency is a criterion for social choices. He states the significance of failure to achieve Pareto optimality merely means that the situation is improvable. (Zeckhauser, 1973) The full application of Pareto criterion in voting system is not possible for several reasons like the lack of information and the non compatibility of comparisons.

The voter should be able to evaluate the outcomes in a non deterministic world and he is obligated to make his decisions under uncertainty.. in addition the voter make his judgment in an ex-ante bases without being able to evaluate if the choices are Pareto efficient. The voting mechanism cannot also represent an efficient outcome, like the case of 2 individuals and three alternative choices.

Another problem is the connection between Pareto's description of democratic plutocracy and his allegation that it is always an oligarchy that governs. (Femia, n. d.) But someone could ask why if a Pareto improvement exists, why do the affected parties not negotiate manually beneficial deal voluntarily? (Lewin, n. d.) Moreover Wicksell in his paper

„Finanztheoretische Untersuchungen“ arrive at a conclusion that no of the known systems don not satisfy the criterion Pareto as all impose the willingness of one group of people to the others (Wicksell 1958)  
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## Imposition of taxes

The more important concern of policy is the optimal sum-taxes through the application of 2nd theorem. But the lump sum taxes cannot be equable tax for consumers as the target is redistribution. The taxes should be different along consumers, which need government to have personal information about consumers preferences, endowments etc. The planner should be able to make the contract curve of Pareto efficient allocations to select the optimum solution. (Arrow, 1983) But for comparisons of efficiency a distribution is Pareto efficient if only every person has equal percentage of distributive item and at least one of them has more. The definition of Pareto efficiency does not need interpersonal comparisons. Moreover under the usual assumption it is not worth if we consider Pareto optimality on a level of well-being or material resources. (welfare justice and Pareto efficiency). The theorem also suggests that social planner should know the distribution of agent types in the population. Tax implementation frequently claimed to be counterproductive because unanimous taxes cannot cause a competitive equilibrium. Moreover Pigouvian observation different social and private costs could not be a reason for taxation. Pareto efficiency is achieved by imposing different taxes for the same good depending to buyer (Mongin, 2010) In the taxes we also have the problem of different bargaining power winners and losers, if the compensation will be offered and how much. (Stavereen, 2006)

## Moral Dimension

According to Walter Schultz the 1st theorem needs a set of ethical conditions in order to ensure the absence of failures and the assumptions of perfect competition to be more realistic. (?) Additionally Pareto law is inconsistent with the effort of heterodox economists in the analysis of how an economy can stint the poverty, inequality and environmental damage. (Staveren, 2006) Moreover Kantian poses an other argument, that people should not be used as means for other people, s ends but they are always ends themselves (Osana, 1972)

Some economists opposedes to pareto's view , especially Vivian Walsh Arued that ethics is part an parcel of economics an not separate of them.