Economics essay sample

Business, Marketing

What can the first and second theorems of welfare economics teach us about economic policy?

What is economic policy?

Economic policy refers to those actions that a government undertakes in order to influence its economy. These Economic actions include regulation of interest rates through Federal Reserve, regulation of the government expenditure, implementing rights of private property, and laving tax rates. Welfare Economics is the method of systematically evaluating economic implications in the alternative resource allocated. Welfare economics deals with weather the sources allocated are efficient and who is going to lose or gain by how much in various allocations (Mark Blaug, 2007).

Fundamental theorems of Welfare Economics

Welfare economics has two fundamental theorems which are as follows:

First theorem of welfare economics

The first theorem of welfare economics is also known as " Invisible Hand Theorem", according to Adam smith. According to which any competitive equilibrium results in Pareto efficient allocation of resources.

Competitive equilibrium and Pareto efficiency

Competitive equilibrium means an economy with mobile resources, too many buyers and seller's trading with perfect information. Pareto efficiency is not same as desirability it just indicates that if something has to be made better than it cannot be done without making something worse and it is also possible that the Pareto efficient resources are not desirable by the society. The market leads to a social optimum through allocation of Pareto efficient

resources which do not need any sort of government intervention it should opt for " laissez faire" policies. Laissez faire is a French word which means " let them do". The trade between the private parties is not restricted by the government, subsidies, tariffs and only property rights are regulated. Those supporting the government intervention say that these assumptions needed are rarely seen in the real life.

First theorem of welfare economics states that in a perfectly competitive market the price system is governed by selfish individuals who are concerned with private well being and maximize their profits to bring the economy to a social optimal state. Price rise due to excess demand and fall in excess supply adjust themselves on their own. Well, it must be noted that the economic condition in which someone has every good and the others have none is a Pareto efficient distribution but is hard to be considered the perfect one under the welfare definition. The second theorem of welfare economics is more reliable (John M Gowdy, 2004).

.

Second theorem of welfare economics

Second theorem states that " out of all possible Pareto-efficient outcomes, one can achieve any particular one by enacting lump-sum wealth redistribution and then letting the market take over". Market mechanism can lead to redistribution resulting in market equilibrium by attaining efficient allocation. It is converse to the first welfare theorem; Market equilibrium can be achieved through lump sum distribution scheme. It gives conditions supported by price equilibrium that transfers and Pareto optimum allocation can be achieved. Redistribution allows selection from the efficient outcome

and distributional equality. If an economic authority wishes to impose efficient allocation as a result of social, economic reason the market does not need to be closed, they need to implement a fiscal policy and allow a competitive market to trade .

Both the theorems taken together helps the government to get relived from working enormously, it needs not decide the consumption and opportunity of every consumer it just has to arrange for initial allocations and let the market take over. Perfectly competitive markets assume entry and exit free of cost, homogeneous goods, perfect information, too many goods suppliers and buyers. The assumptions in the first and the second theorem of welfare economics are consumer sovereignty regarding selfish monolithic utility functions, and instead of initial distribution wealth can be redistributed. The property right applies to individual and not the whole economy. No paternalism is their consumer sovereignty is accepted the demand and supply depends on the individual cost and benefits.

Works Cited

Blaug, Mark. " The fundamental theorems of modern welfare economics, historically contemplated." History of Political Economy 39. 2 (2007): 185.

Gowdy, John M. " The revolution in welfare economics and its implications for environmental valuation and policy." Land economics 80. 2 (2004): 239-257.

Osborne, Martin J. Pareto efficiency. 20 March 2014 .