Welfare Economics: A Story of Existence

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Abstract

The purpose of this study is to explore that, despite severe challenges, welfare economics still exists. This descriptive study is conducted through some specific time line developments in this field. Economists are divided over the veracity and survival of the welfare economics. Welfare economics emphasizes on the optimum resource and goods allocation with the objective of better living standard, materialistic gains, social welfare and ethical decisions. It origins back to the political economics and utilitarianism. Adam Smith, Irving Fisher and Pareto contributed significantly towards it. During 1930 to 1940, American and British approaches were developed. Many economists tried to explore the relationship between level of income and happiness. Amartya Sen gave the comparative approach and Tinbergen pioneered the theory of equity. Contemporarily the futuristic restoration of welfare economics is on trial and hopes are alive. This study may be useful to understand the transitional and survival process of welfare economics.

Keywords: Welfare *Economics, Utilitarianism, Pareto Criterion, Comparative Approach, Equity, Capability Approach and Happiness.*

JEL Classification: *D60, D80, D90.*

Introduction

Economists are split over the existence of welfare economics, one group is skeptical and considers it obsolete while the other welfarists think that the skeptical group may be convinced and consensus can be developed over this issue (Harberger, 1971). It has been often argued that the death of welfare economics is foretold but Sen and others hold hope and claim, on solid reasons, that welfare economics is back (Sen 1999a; Fleurbaey and Mongin 2005).

This study is based on the descriptive and thematic method and it looks into the pages of history of welfare economics to analyze the different approaches in its prevailing literature. Keeping in view the historical perspective, I have tried to narrate its story of existence. By evaluating the obsolete and emerging literature, it

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has been concluded that despite different trials welfare economics exists and will continue.

Welfare Economics is concerned with defining and measuring the social welfare. It evaluates the consequences of individual and public decisions on social welfare (Baujard, 2015). How economic activity affects the individual welfare is the main theme of welfare Economics (Gintis, 1972). Welfare Economics is the branch of economics that has a focus on the optimum resource and goods allocation with the objective of social welfare. Economic welfare refers to the better living standard and a privileged condition of a person or a group of persons. It is a subpart of social welfare that is met through the utility and materialistic gains of goods and services (Samuelson, 2004). Welfare economics is the moral evaluation of economic systems (Gravelle and Rees, 2008). Welfare is taken as wellbeing that flows from the distinct objectives and choices; and it is measurable (Bernheim, 2008).

The fundamental determinants of welfare are employment, labor conditions, leisure, consumption, production and utilization of environment (Hueting, 2011). Human welfare's key determinant is consumption of goods and services (Deaton, 1980). An individual's welfare is dependent on the fabric of community, working conditions, psychic condition and working conditions. New classical analysis is deficient in education, work, consumption and technology. When individual welfare is aggregated it becomes social welfare (Gintis, 1972).

Welfare economics is different from the rest of economics due to its nature and scope it deals with ethical decisions. The ethical principles and social policies are evaluated and prescribed on the basis of the principles of welfare economics. The language of welfare economics is also ethical and moral but purpose underlying the language is much important. Welfare economics and ethical rules are inseparable and it belongs to metaphysics (Archibald, 1959). Most of the people opine of that social welfare considers about the inequality, poverty, civil rights, liberties and opportunities to enjoy. The welfare economists had have been involved in the content of measurement both descriptive and evaluative. During the last four decades, welfare economists have tried to explore these issues and solve these riddles.

"Social welfare" is related to social policy in any sensible interpretation; the welfare judgments formed by any single individual are unconnected with action and, therefore, sterile. (Arrow, 1963, p.106)

The ethical inferences and scientific hypothesis cannot be accepted and tested in the same way but it doesn't mean that welfare economics has no scope. It is a legitimate exercise in economics to analyze the value based decisions and their fallouts (Samuelson, 1947). Presently, welfare economics is not given its due importance and it is merged in General Equilibrium and microeconomics (Atikinson, 2001&2009).

Welfare economics cannot be comprehended without looking into the chapters of history which explain it evolution and culmination (Blaug, 2015). The origin of welfare economics is as olden as of political economics. Welfare economics emerged when institutions were adopting professionalism, British welfare state was at initial stage and religion was not a separate entity (Backhouse and Nisizawa, 2006). The focus of Classical and neo-classical economists was on productivity and parity of productive systems that how these had evaluated and allocated goods and labor for the society (Myint 1965). Welfare Economics stems from Utilitarianism that tried to define the tools of measurement of wellbeing. The evolution of welfare economics is marked with different phases along with their contributions.

Adam Smith (1776) played a key role in the development of welfare theory by giving the idea of invisible hand and the value paradox. Individual's advantages naturally and ultimately turn into the advantage of society. Invisible hand as a central planner operates economy in such a way that it attains social optimum (Cantollon, 1993). The pro-Smithians are proponents of *laissez-faire* and they believe in free market (Milgate, 1987). Welfare economics had theoretical basis on competiveness, equity and social welfare. Every individual is concerned with his own interest but unknowingly he promotes public interest and generates revenue for the society (Milgate, 1987).

Adam Smith tried to explain the "Water and Diamond Paradox". The things having great value in use have a little in exchange and contrary to this the things that have great value in exchange have no value in use. Water and diamond are examples of this (Smith, 1776).

Henry Sidgwick and Thomas Hill Green (former at Cambridge and later at Oxford) were key figures during 1870 to 1914 in the story of welfare economics. Both were friends since their childhood and they contributed to welfare economics greatly. They belonged to the group of "economic liberals" which joined politics in 1960. Sidgwick's *Methods of Ethics* (1874), Green's posthumous *Prolegomena to Ethics* (1883) are glaring examples of their contribution. Both had inspirational power for their generation but their paths diverged later on. The reformation of the society was required on rationality basis to counter church hegemony and aristocracy. Gladstone's hopes met with failure due to the dominance of clerics so that educational reforms were needed. Green remained with the Church and construed Christianity on ethical grounds which inspired students. John Ruskin denounced political economy and commercial society. Green, Toynbee the pupil of Green and Ruskin had inspirational charisma for students and counterparts for the settlement movement.

Contrary to this, Cambridge welfarists were academically sound and professional, especially Pigou. Marshall tried to professionalize the economics but official history begins with Pigou. The Oxford Group was inclined towards organizations which were influential on policy. The adoption of welfare policies by Churchill and Lloyd was by dint of Fabians not economists whereas Sidney and Beatrice Webb were linked with economists.

Leon Walras (1874) introduced the general equilibrium comprising of the principles of utility maximization and profit maximization. He exhibited that relative prices impact the behavior of consumers and firms.

From the times of Adam Smith welfare was correlated with self-interest and competition but Marshall took exemptions to it (Arrow, 1951). At an early juncture of welfare economics, the idea of consumer surplus was developed and it origins back to work of Marshall, Jules Arsène Dupuit and others. Consumer surplus is a notch of welfare, it measures the variation in consumer's utility and a policy recommendation may be derived from this. The difference between what, a consumer is willing to pay for a good and what, actually, he is paying for that good is consumer surplus. Graphically, this is the area beneath the demand curve. It is very helpful when economic policies are being evaluated. Jules Dupuit (1844) raised the question that the value of exchange in not enough for measuring welfare. Dupuit emphasized on consumer surplus which is part between demand curve and budget or price line whereas producer's surplus falls in part between budget line and supply curve.

It was American economist Irving Fisher who advocated that the welfare rises if someone gains and no one loses whereas welfare decreases if some person gains and some loose then there is ambiguity about the welfare change. Later on this partial ordering was termed as Pareto Criterion.

There were two rival traditions one related to Pareto and other to Pigou (Blaug, 1997). Vilfaredo Pareto contributed significantly to the existing theory and gave the notion of ophelimity in economics. Pareto adopted contract curve and Edgeworth box (envisaged by Frncis Ysidro Edgewort, 1881) to illustrate his optimality.

Arthur Cecil Pigou (1877-1959), the student of Alfred Marshall and class fellow of J.M Keynes, produce the modern welfare theory in his book "The Welfare of Economics (1920)". Cecil Pigou proved his spirit for neoclassical tradition and theorized on economic marvels (Mclure, 1999). He introduced externalities and differentiated between private and social cost. When private and social costs are equal then there is an efficient allocation of resources. Pigou also provided insight into the public goods which later on led to the marginal cost of public funds.

According to Pigou negative externalities can be measured in money through cost benefit analysis. Further, he elaborated that trade net product can be maximized but not social net product due to the negative externalities. Pigou prescribed to eradicate the gap between trade and social net product through leaving taxes. This tax should be equivalent to the marginal external cost. Coase also supported the imposition of tax to the polluter through common law (Milgate, 1987).

When production and consumption are efficient then there is Pareto's optimal allocation of resources. Economic welfare is higher for the society if pre-transfer and post-transfer situation does not result in welfare loss of any body. *"A social state is hence said Pareto optimal if it is not possible to improve the situation of certain individuals without making the situation of at least one other individual worse off".*

Lionel Robbins's "Essay on the Nature and Significance of Economic Science" hit the Pigouvian welfare economics and paved the way to the modern welfare economics. Pareto criterion left the distributional problem unresolved. Abraham Bergson proposed welfare function to meet the distributional problem. Welfare function is an increasing function of utility function.

The primary theorems of welfare economics, based on Pareto's notions, can define better the social optimum. Oskar Lange, Abba Lerner and Harold Hotelling gave FOC (First Order Condition) for economic efficiency and proved the proposition. The general welfare can be maximized through maximizing, allocating and transforming. Utility is maximized, if MRS is equal between two goods and two individuals. When MRS (Marginal Rate of Substitution) and MRT (Marginal Rate of Transformation) is equal between two goods then it is optimal allocation. MRT (Marginal Rate of Transformation) in two goods of the firms should be equal for efficiency.

"The first theorem of welfare economics states that competitive equilibria are Pareto-optimal, if individual preferences are monotonic and if there are complete markets. The second fundamental theorem of welfare economics states that one can achieve any Pareto-optimal allocation in a competitive equilibrium when the social planner undertakes an appropriate redistribution of endowments".

When consumers are at such an equilibrium point that no shift can made them better off is called Pareto optimal. It denies that utilities of two different consumers can be compared. It also proclaims that there can be many Pareto optima (Milgate, 1987).

During 1930 and 1940, both British and American approaches of the new welfare economics were developed. The British approach is erected on the considerations of Nicholas Kaldor (1939), Tibor Scitovsky (1941) and John Hicks (1941), and it envisaged the idea of Pareto improvement to avoid the problem of comparisons. They suggested "Pareto efficiency criterion' which land on hypothetical thoughts and unanimity. Kaldor (1939) favored the repealing of Corn Laws in England subject to gainers to losers but it was challenged by Scitovsky (1941) at the name of inconsistency.

"The change would be a Pareto-improvement, i.e. would be unanimously better, if such compensations were made. In all cases, this change passes the test of hypothetical compensations and is considered to be "Pareto-efficient", then could be recommended".

Both Economists and politicians should contribute to policy making, prior are not liable to decide but later resolve that how transfer should be made. In this way consumer surplus lead to the adoption of cost benefit analysis.

The critics of welfare criteria, argue, that it arise erratic outcome of policy recommendations unless wealth and consumer preference are constant. Chipman and Moore concluded in 1978: *"judged in relation to its basic objective of enabling economists to make welfare prescriptions without having to make value judgments and, in particular, interpersonal comparisons of utility, the New Welfare Economics must be considered a failure."*

The American approach is related with Abram Bergson and Paul Samuelson of United States. Bergson pronounced that welfare is function of product, consumer goods, work, non-labor elements, environment, utility function and the Pareto criterion- based on value judgments. In 1949, the logician Olaf Helmer put questions to Kenneth Arrow about the aptness of welfare function and social preference. After one year Arrow (1963) replied that three individuals' preferences can be aggregated in one preference rationally. A collective judgment cannot be ascertained from individual preferences except it is autocratic so that it makes no sense of collective welfare. New welfare economics was destined to failure but not materialized luckily.

In 1950, Richard Easterlin exhibited that income increased the level of happiness in people. He re-asserted in 1974 that people with higher levels of incomes had more contentment and happiness but this level of bliss does not change much where per capita incomes are high. During 1960 to 1970, it was observed in USA that there was no rising trend of happiness. Income and wealth are not ultimate sources of happiness and bliss. Economics of happiness is positive and it is concerned with what is but not with what should be. Happiness is not only dependent on the consumption of goods but on many other things like quality of life, wellbeing and inner satisfaction. It is also difficult to measure the level of happiness we have to depend on self-assessment scales for this.

Many economists attempted to explore that why not growth of national income increase the level of happiness and wellbeing of the people. They found that poverty crumbles the happiness and rise in income for poor is much source of happiness as compared rich person. Unemployment is detrimental of the happiness. Happiness can be attained by curbing inequalities, increasing leisure, hazardless working conditions, less working hours, unemployment allowances and through social reforms. A group of economists is opined of that happiness is measureable with the yardstick of money which pave path for the cost benefit analysis. The determinant measure of happiness is of key importance for the policy makers. The survey methods are not good interpreter and their reliability is also doubtful. The policy makers should keep in view that happiness of individuals is their responsibility and they should be generous in this regard. Happiness is needed but not ultimate and it is not barometer of public effort (Davoine, 2009).

Amartya Sen favored quality of life over utility and wealth by giving “comparative approach”. This approach emphasized on “individual basis for justice” for the quality of life and welfare. It is good quality of life, if goods are at human discretion to turn into for their wellbeing. It is capability of a person through which he achieves a collection by choosing. The capabilities transform commodities for wellbeing and freedom of will (Sen, 1985). The capability approach assesses individual and general welfare conditions. Its main notions are functionings and capabilities, prior are basics of living to accomplish and achieve whereas later are ability to get. The later also reveals the freedom of choice to live differently (Parr and Kumar, 2003). Capability includes education, change in thinking style, increasing competency, dynamism and economic freedom (Palit, 2014).

The theory of equity is based on social choice theory and notion of ‘no-envy’ was envisaged by Tinbergen, Foley and advanced by Kolm, Felfman and Kirman. An envy free allocation is that where no one considers others basket better. The equity criterion is comprised of both no-envy and Pareto features. People of same traits and aptitude should not be envy of each other. The theory of equity conquered the Arrovian impossibility and mitigated the challenges of welfare economics.

Conclusion

This study leads to the conclusion that welfare economics has had a history of happiness and goodness along with, competitiveness, equity, wellbeing and gains of human. Over hundred years, welfare economics was subjugated by utilitarianism but its new phase was started by Jeremy Bentham, Henry Sidgwick, Alfred Marshall and A.C. Pigou and many others. Happiness is very crucial for advantage and wellbeing as a base of social evaluation and public policy. Utilitarian theory, for decades, maintained the status of “the official theory” of welfare economics. Contemporarily a good chunk of welfare economics is constituted of utilitarianism. The element of happiness is ignored in economic issues. Now a days, in many parts of world, people are much richer but less happy (Sen, 2010). Indeed, there are different trials on the futuristic restoration of welfare economics and divergence amongst the economists over it but still hopes are alive. The revival of welfare economics will open up the new window of opportunities. So the story of existence of welfare economics is continuous and will continue till the humanity exists.

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