Welfare Economics

Pareto Efficiency

This microeconomic analysis leads to the condition of Pareto efficiency as an ideal in welfare economics. When the economy is in a state of Pareto efficiency, social welfare is maximized in the sense that no resources can be reallocated to make one individual better off without making at least one individual worse off. One goal of economic policy could be to try to move the economy toward a Pareto efficient state.

To evaluate whether a proposed change to market conditions or public policy will move the economy toward Pareto efficiency, economists have developed various criteria, which estimate whether the welfare gains of a change to the economy outweigh the losses. These include the Hicks criterion, the Kaldor criterion, the Scitovsky criterion (also known as Kaldor-Hicks criterion), and the Buchanan unanimity principle. In general, this kind of cost-benefit analysis assumes that utility gains and losses can be expressed in money terms. It also either treats issues of equity (such as human rights, private property, justice, and fairness) as outside the question entirely or assumes that the status quo represents some kind of ideal on these type of issues.

Social Welfare Maximization

However, Pareto efficiency does not provide a unique solution to how the economy should be arranged. Multiple Pareto efficient arrangements of the distributions of wealth, income, and production are possible. Moving the economy toward Pareto efficiency might be an overall improvement in social welfare, but it does not provide a specific target as to which arrangement of economic resources across individuals and markets will actually maximize social welfare. To do this, welfare economists have devised various types of social welfare functions. Maximizing the value of this function then become the goal of welfare economic analysis of markets and public policy.

Results from this type of social welfare analysis depend heavily on assumptions regarding whether and how utility can be added or compared between individuals, as well as philosophical and ethical assumptions about the value to place on different individuals' well-being. These allow the introduction of ideas about fairness, justice, and rights to be incorporated into the analysis of social welfare, but render the exercise of welfare economics an inherently subjective and possibly contentious field.