

Topics in Public Policy: An Introduction to Welfare Economics

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April 12, 2012

1 Practical Matters

1. Students can achieve six credit points from this course and these can be awarded either in the elective module *Advanced Public Policy* or in the elective module *Macroeconomics and Labour*.
2. Classes are scheduled to take place on Wednesdays from 12.00 to 2.00 PM and Thursdays from 2.00 to 4.00 PM in room HS I (ReWi II) from April 25, 2012 onwards.
3. Office hours are by appointment.

2 Overview

This course is designed to serve as a rigorous introduction to welfare economics. It is borne out of the conviction that students of public policy should have the opportunity to engage with the critical insights of welfare economics at a foundational level. Most public policy choices affect a large section of society and typically these affects are very asymmetric—there are winners and losers associated with any such choice of policy. The primary objective of the course is, therefore, to equip students with a “language” with which they may critically engage with the following questions: What are *normatively* satisfactory ways of accounting for the asymmetric effects that any public policy decision may have on various members of society? Or alternatively: Are there *normatively* satisfactory ways of reconciling the divergent preferences that members of a society may have over alternative public policy

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choices? A central lesson of the course will be to acknowledge the difficulty—both analytical as well as ethical—that the aforementioned questions pose at a foundational level.

We will begin the course with a discussion of the *primitives* on which neo-classical welfare economics is based. We will highlight that one of the critical assumptions here is that of *methodological individualism*. Methodological individualism is the doctrine which argues that individual motivations, desires and behavior are the basic building blocks from which any analysis of the “social,” including social welfare should be built. In other words, the individual precedes the social and individual realities must themselves exist as *stable* referents from which the social reality is constituted, not the other way round. We will then proceed to see that even within the realm of methodological individualism the picture is far from uniform. There is the tricky question of what kind of “data” about individual desires and motivations should form the building block for any welfare analysis, be it at the level of the individual or society as a whole.

We will then engage with Social Choice Theory and the most important contribution of its pioneer, Kenneth Arrow, arguably the most influential economist of the second half of the twentieth century. In his famous *Arrow’s (Im)Possibility Theorem* we will see the logical implications of building a theory of social welfare from the primitives about individual desires and motivations that neo-classical economics considers admissible. In this part of the course, we will also learn about other classic results like the *Gibbard-Satterthwaite Theorem* and the *Liberal Paradox* as well as discuss various social decision mechanisms (eg. majority rule voting) that societies often rely on to arrive at social decisions. Thereafter, we will examine the difficult issue of making interpersonal comparisons of “utility.”

In the next part of the course, we will study about the welfare theoretic properties of market allocations. We will spend a fair amount of time understanding the welfare theorems, in particular the conditions under which they apply and their content for public policy. We will also study the effect of asymmetric information on market allocations and the concomitant welfare implications.

We will then spend some time thinking about the issue of inequality, broadly defined. By almost any measure, inequality patterns around the globe are rising. These patterns pertain not only to inequalities in such measurables as income and wealth but also in the unequal *say* or *voice* that different sections of society have in matters of public policy. In this section we will address the issue of inequality both from a philosophical viewpoint by appealing to theories of distributive justice as well as from a “practical” one by relating it to public policy choices of the last two decades or so.

Finally, we will consider the potential contribution that the field of behavioral economics can make in answering key questions in welfare economics. Behavioral economics tries to

go beyond the straitjacket of Revealed Preference Theory by seriously engaging with the psychological processes involved in individual decision making. In so doing, it emphasizes the internal conflicts that individuals face in making choices. We will try to understand the ramifications of such internal conflicts for matters of public policy.

3 List of Topics

1. Foundations
 - (a) Methodological Individualism
 - (b) “Mindful” vs “Mindless” Economics
 - (c) On the Notion of “Rationality”
 - (d) On the Methodology of Economics
2. Social Choice Theory
 - (a) Arrow’s (Im)Possibility Theorem
 - (b) Gibbard-Satterthwaite Theorem
 - (c) Sen’s Liberal Paradox
 - (d) Voting Rules
 - (e) Interpersonal Comparisons of Utility
3. Markets, Efficiency and Welfare
 - (a) Arrow-Debreu Economies and General Competitive Equilibrium
 - (b) The Welfare Theorems
 - (c) Asymmetric Information and Market Allocations
4. On Inequality
 - (a) Equality of what?
 - (b) Theories of Distributive Justice
 - (c) Markets, Globalization and Inequality
5. Behavioral Public Economics
 - (a) Welfare Analysis with “Non-standard” Decision Makers

- (b) A Behavioral Economics Analysis of Savings Behavior
- (c) A Behavioral Economics Analysis of Poverty
- (d) On “Nudges”

4 Textbooks and Readings

For parts of the course, I will draw from the following sources.

- *Microeconomic Theory* by Andreu Mas-Colell, Michael Dennis Whinston, Jerry R. Green. Oxford University Press, 1995.
- *Inequality Reexamined* by Amartya Sen, Russell Sage Foundation; Clarendon Press, 1995
- *Beyond the Invisible Hand: Groundwork for a New Economics* by Kaushik Basu, Princeton University Press, 2010.
- *Freefall: America, Free Markets and the Sinking of the World Economy* by Joseph E. Stiglitz, W. W. Norton & Company, 2010.
- *Nudge: Improving Decisions About Health, Wealth, and Happiness* by Richard H. Thaler and Cass R. Sunstein, Penguin, 2009.

I will provide you with a list of other references as we go along.

5 Prerequisites

1. We will be dealing with several challenging issues which have been elaborated by major thinkers. Most of these issues defy easy solutions, so the critical analytical task is to patiently follow through difficult formal models without being intimidated by them, including being able to work through proofs of formal theorems. If your schedule does not allow you put in the investment that this course requires, I will strongly encourage you to take this course some other time.
2. Regular attendance is very important for you to understand and keep pace with the material covered in class. Please make attendance a priority.
3. At several times during the semester you will be expected to present on course material and lead class discussions. I want you to take these presentations very seriously

and therefore do a thorough job of engaging with the course material and with your colleagues in class.

4. The goal of this course is not to prepare you for an exam, but instead to prepare you to understand and participate in research being done at the frontiers. Therefore, your attitude should be geared towards understanding of concepts and analytical methods.

6 Evaluation

The grade for this course will be based on a term paper. The topic of the paper should be related to one or more of the five broad areas listed in section 3. There are several components to the term paper. Please read these carefully.

1. You should propose a topic for approval to me no later than May 31, 2012. This submission should be about one page of text, with one page of bibliography.
2. The first draft of the term paper is due on June 13 and 14, 2012. You will also be making a presentation to the class on your paper. The goal of your presentation is to get constructive feedback from your colleagues so that you may gain further clarity about your project. It is essential that everyone takes a great interest in helping each other do their best on their respective projects.
3. The final paper is due on July 4 and 5, 2012. Once again, you will make a presentation. This time the goal will be to see how you can further extend your paper and make it suitable for potential publication at a future date.