

Some notes on class 1:

There are a number of theoretical reasons for policy interventions in a world with market imperfections. To start understanding those, it is useful to compare with theorems based on assumption of a “perfect world”.

The perfect world:

First Fundamental Theorem of Welfare Economics (proved by Arrow and Debreu, 1954):

“If the exchange of goods or services is subject to complete contracts (called the market completeness assumption), all equilibria supported by competitive exchange are Pareto optimal.”

- ⇒ Note that this theorem says nothing about distribution. It points out that in the perfect world with no market imperfections and perfect competition, even with very unequal distributions, one automatically obtains a situation (equilibrium) in which it is impossible to make somebody better off without making somebody else worse off. Hence in this world, and distribution of income ex-post will be inefficient.

Second Fundamental Theorem of Welfare Economics:

“Given convexity (i.e. ruling out increasing returns), and market completeness assumptions, any Pareto-optimal allocation can be supported as a competitive equilibrium for some assignment of initial endowments.”

- ⇒ This theorem points out that to reach a certain desirable outcome (e.g. one with an equitable distribution of income) all one needs to do is assure the correct distribution of initial endowments, and then the market (and more specifically, the individual incentives provided by the market) will take care of obtaining the desired Pareto optimal outcome.

Hence in this perfect world, the effect of redistributing income is reducing incentives and therefore there is an equity-efficiency trade-off. Nevertheless, there seems to be a way around it by distributing initial endowments rather than ex-post income. However, while this holds theoretically in a static world, it is less relevant in practice given the dynamics involved. Redistribution of assets will still affect incentives, as governments typically can't credibly commit to doing this only once (at some “initial” stage).

It is this equity-efficiency trade-off that makes some economists warn against (too much) market interventions. And while in this world, both equity and efficiency might still be desirable policy objectives, they need to be considered separately, and the trade-offs between the two acknowledged. This is the win-lose world. Policy interventions will automatically lead to winners and losers.

The imperfect world:

Once we leave the perfect world, there are however win-win situations.

Stiglitz and co-authors have shown that market imperfections mean that, at least theoretically, there are always interventions that will be able to make many better-off without making anyone worse off. If such interventions are targeted at the market imperfections that specifically hurt the poor, efficiency and equity can jointly be improved.

One last important theory in this debate however is the theory of the second best:

In a situation of multiple market imperfections or distortions: taking away one market imperfections might lead to a Pareto inferior outcome.

Note that while this theory is not inconsistent with Stiglitz' results, it does mean that the later only holds if all the right interventions are taken at once (or in the right order, also known as the "gradual" approach). This calls in fact for very careful policy planning and analysis of the contexts, and all relevant factors within that.

Finally, while it is clear that we hardly ever are in the "perfect world", the welfare theorems provide a useful benchmark, and more importantly, remind us of some important lessons:

- 1) Under the right conditions, individuals acting autonomously in pursuit of their own interests may implement socially desirable outcomes. The policy challenge then becomes to create the right conditions. And vice versa,
- 2) Given that individuals will pursue their own interests, the design of policies should always be incentive compatible.

Why Study the Micro-economics of Development ?

Micro-economic foundations to many problems in developing countries:

Market imperfections (& weak law enforcement):

- Imperfect competition
- Imperfect information
- Externalities
- Public goods

- ⇒ Affect choices of utility maximizing individuals, households, leaders, policy makers
- ⇒ Different types of (informal) institutions
- ⇒ (Asset) Inequality matters!
 - ⇒ Not always an efficiency-equity trade-off
 - ⇒ Instead poverty traps

⇒ Implications for policies and policy outcomes