The Ethics behind Welfare Economics
A Philosophical critique

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Abstract

In the last two decades an increasing number of literature has come forth exploring the relations between Ethics and Economics. It shouldn’t be surprising that a social science, such as Economics, which has in Adam Smith (a moral philosopher) one of its most important founding figures, still bears some relationship to Moral Philosophy. Yet, to say that there are Ethical considerations underlying Economics seems surprising to some economists who think that a science such as Economics is, or ought to be, free from value discussions. In Part I of this article a brief presentation of Welfare Economics is made. Chapter 1 focuses on the concept of rationality, which is central to understand how Economics portraits human behaviour in its models. Chapter 2 focuses on concepts such as that of Pareto optimum, and the welfare theorems of economics, which are used as criteria for assessing and comparing different welfare outcomes. Chapter 3 presents three kinds of ethical theories on well-being: hedonism, desire theories, and objective list theories and discusses some of the difficulties of desire theories that apply to welfare economics. Part II is a critique of the welfare view stated in Part I. Chapter 4 discusses Economics’ concept of rationality and its flaws, the problems with revealed preference, and some remarks about interpersonal comparisons of utility. Chapter 5 is the core of the critique to welfare economics, where the view on welfare presented in chapter 2 will be confronted with some of its problems. The article ends concluding that welfare economics should at best be seen as a partial or incomplete theory of welfare, one that works at best as an approximation for welfare in market related situations.

Keywords: Philosophy of Economics; Ethics and Economics; Welfare Economics; Pareto optima; Cost-benefit analysis.
Introduction

The aim of this article is to criticize welfare economics from a philosophical point of view, and to show its hidden ethical commitments. Part I is a presentation of welfare economics and the three main ethical theories of welfare. The critic of welfare economics will be concentrated mostly on Part II, but throughout Part I some critics can also be found. Since we don’t presuppose that readers have any background knowledge in economics, before we start some definitions and contextualization of economic science are necessary. This introduction will briefly present what we mean by ‘economics’ and some important discussions that had influence in the development of this science which will be important throughout the rest of this article.

1. What is economics?

Lionel Robbins in 1932 defined economics as the “science which studies human behaviour as a relationship between ends and scarce means which have alternative uses” (Backhouse 2002: 3). Today this still remains as one of the most cited definitions of economics. Although both the definition and domain of economics are still subject of controversy (Hausman 2013), with Robbins’ definition we get that economics studies human actions in conditions of scarcity, where the problem of how best to satisfy an end occurs. Following this line of thought we can view phenomena normally associated with economics (prices, money, production, markets, bargaining) as consequences of scarcity, or ways in which people try to overcome the problem of scarcity (Backhouse 2002: 3). Another important definition is Marshall’s view of economics as “the study of mankind in the ordinary business of life” (Backhouse 2002: 4), or how production is organized to satisfy human wants. Other definitions portray economics as the science of choice, or the study of markets. Though none of these definitions is consensual, they’re all in some way related to problems of choice, human ends and needs. Difficulty in defining economics comes, in part, from the fact that there are many diverse schools of economics (for example neoclassical economics, Marxian economics, institutional economics) each focusing more in one or other particular aspect (in what regards this essay we will focus on what is called “neoclassical economics”, or “main-
stream economics”\(^1\). On the other hand, in the second half of the twentieth century economists have expanded economic models to areas which weren’t traditionally\(^2\) the subject of economics. Gary Becker, for example, tried to explain things such as marriage decisions or crime rates using economic models. It seems today, for many economists, that any choice situation could be modelled by economics.

2. Brief historical contextualization of economics

Though we can trace thought on (what are now considered) economic problems to at least ancient Greece, economics only came to be a separate science in the 18th century (Hausman 2013; Backhouse 2002). Some of the pioneers of economics (as a separate science), Adam Smith, David Ricardo, John Stuart Mill, to cite a few, are often referred to as “classical” economists. They recognized mechanisms through which individual actions could result in systematic consequences without any need of government control (Hausman 2008: 23). Smith’s “invisible hand”\(^3\) is a paradigmatic example of this. They wrote in a time (and place), where capitalism was emerging to become the dominant mode of production and market trade was expanding. It is no surprise that for these economists “their emphasis was on production and on the factors that influence the supply of consumption goods” (Hausman 2008: 24).

In the end of the nineteenth century, with the neoclassical, or marginal, revolution, economists shifted their concerns from production to individual choice and exchange. From this revolution neoclassical economics was born. One scholar defines neoclassical theory as a metatheory of economics: “a set of implicit rules or understandings for constructing satisfactory economic theories”. Its fundamental assumptions include “1- people have rational preferences among outcomes; 2- Individuals maximize utility and firms maximize profits; 3- People act independently on the basis of full and relevant information.” (Weintraub 2002). Historically early neoclassical economists were heavily influenced by utilitarianism. William Stanley Jevons, one important figure in this period, developed the notion of a utility function, in which

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1. Throughout the rest of this paper we’ll refer to neoclassical economics simply as economics, as it is done in most economic literature.
2. By traditional areas of economics we mean market and money related issues.
3. In short, the idea that individuals pursuing their self-interest in the market produce the most socially efficient outcome to society, as though they were guided by an “invisible hand”.

every option available to an individual results in an amount of utility to that person. Rational action came to be identified with the maximization of utility. Neoclassical economics assumed also that individuals are non-satiated—individuals always prefer a larger bundle to a smaller one if the only thing in which the bundles differ is in the quantity of goods (Hausman 2008: 26)—in simpler terms, more is better. Their focus was on commodities and choices between bundles of goods. These early neoclassical economists also developed the idea of diminishing marginal utility— as one consumes an additional unit of a good, that additional unit provides a smaller increment in utility than the previously consumed unit of the same good had provided\textsuperscript{4}. The economists who developed this notion were called “marginalists”.

Later on, utility came to be reformulated in economics. It no longer is some sensation that individuals want to maximize (as it was for the utilitarian economists), but a way to speak about preferences. “The utility of some object of choice \( x \) to agent \( A \) is larger than that of option \( y \) if and only if \( A \) prefers \( x \) to \( y \).” (Hausman 2008: 27). In chapter 1, we’ll say more on this. With this reformulation, as utility came to reflect only the ordering of preferences, interpersonal comparisons of utility were abandoned—utility functions are no longer cardinal, but ordinal. Current day economics does not compare utility across individuals. Chapters 2 and 4 explore the question of interpersonal comparisons of utility, where for one author lie some of the problems of mainstream economics. Influential on all these changes was the parallel discussion of the status of economics as a science.

3. Positive and normative economics: Facts and Values

One important distinction is made in economics between positive and normative economics. Though the distinction isn’t altogether clear, “positive economics is the study of the economy, as it currently exists (for example the discernment of facts). Positive economics can be used to make predictions, based on models of how the world works.” (Wright 2015: 22). Positive economics is allegedly concerned with facts, not values. On the other hand, “normative economics entails a judgment about the kinds of actions that ought to be taken.” (Wright 2015: 23). Normative economics is where ethical commitments are. Influential on this distinction between evaluative questions and the

\textsuperscript{4}. An example would be consuming apples. If I desire an apple the first one I consume will give me more utility than the second. If eat a third apple that apple will give me even less utility that the one I previously consumed, and so forth.
“positive” science of economics was Lionel Robbins, who in the 1930’s, said: “it does not seem logically possible to associate the two studies [ethics and economics] in any form but mere juxtaposition. Economics deals with ascertainable facts; ethics with valuations and obligations.” (Hausman & McPherson 2006: 19). Robbins’ view came in a period where economists believed that economics needed to be “value neutral” in order to be a science. Hausman &McPherson (2006: 20) offer a picture of what is the view of some economists regarding this point:

“Economics is science or engineering. It shows how to arrive at certain goals but, unlike ethics, it does not prescribe what goals one should have. Economics provides technical knowledge that has no more to do with ethics than does geometry or physics. No matter how sensible and well-conceived ethical theories may be, they have nothing to do with economics and cannot possibly help one understand economies.”

With this view of economics being dominant in the last decades, positive economics became the main part of economics. Welfare Economics, “the normative branch of economics: (...) concerned with what is good and what is bad rather than what is.” (Feldman, A; Serrano, R; 2005: 1) suffered a “strange disappearance”, in the words of Atkinson (2001), which still persists today. In his article he claims “The study of welfare judgments, (...), is no longer a mainstream subject and is not regarded as an essential part of the economics curriculum. The ‘strangeness’ is that, despite the prevalence of welfare statements in modern economics, we are no longer subjecting them to critical analysis.” (Atkinson 2001: 193). Although it “disappeared”, normative economics is not dead, because it is not possible to make “positive” science solely on the basis of facts or “objective” truths. At the core of positive economics there always must be normative commitments- normative economics. The aim of this article is precisely to subject welfare economics to a critical analysis and show how economics is linked to ethical considerations. In chapter 2 we’ll see some ethical commitments that are taken in welfare economics, which will be later criticized in Part II. Part I follows, from Chapter 1, with the way economics portrays human behaviour- Rationality.
Part I- The ethical assumptions of Welfare Economics

Chapter 1- Rationality

The objective of this chapter will be to answer the question of what is meant by rationality in economics. We’ll also try to briefly present some features of utility theory, revealed preference, and how rationality and individualism come together to form explanations of economic phenomena.

1. Theory of Rationality

Rationality in economics is related to a context of choice. In trying to study how people choose among available alternatives economists assume that individuals choose rationally. In economics choice is the result of an agent’s beliefs and preferences (or desires). A choice is rational when it is determined by rational beliefs and preferences (Hausman 1996: 13). What is it then, to have rational beliefs and preferences? Preferences are rational if and only if they are complete and transitive. Generally, “an agent A’s choices are complete if for all options x and y, either A prefers x to y, or A prefers y to x, or is indifferent between x and y. A’s preferences are transitive if for all options x, y and z, if A prefers x to y, and y to z, then A prefers x to z; and if A is indifferent between x and y, and y and z, then A is indifferent between x and z” (Hausman, 1996: 14). Completeness simply states that individuals are able to compare options and say which one they prefer, while transitivity is a condition that these preferences must satisfy. These two axioms form the core of what is meant by rational preferences. In cases of risk (where probabilities of outcomes are known) and uncertainty (where probabilities of outcomes are not known) preferences must also satisfy other technical conditions in order to be rational (reduction postulate and independence principle) which we will omit, because they aren’t important for our discussion here. One further assumption applies to preferences: they must be context independent, which means that an individual’s preference between x and y should be independent of the fact that z is available or not (Hausman 1996: 16). Another assumption which applies to choice is that individuals always choose the most preferred option.

We can now answer the first question of this chapter. What is meant by ra-

5. Other axioms usually stated are reflexivity, continuity and convexity. Reflexivity is the idea that an individual should value an option x at least as well as x itself. This is already implied in the completeness axiom. Continuity and convexity are technical restrictions that permit the mathematical treatment of preferences, and its discussion would be redundant here.
tionality in economics is to have rational preferences, which means complete, transitive and context independent preferences; and to choose rationally, which means to choose always the most preferred option based on rational preferences. This model of rationally is called utility theory.

1.1 Utility Theory

With complete and transitive preferences, it is possible to establish what is called a ‘weak ordering’ of any finite set of preferences, which allows for the construction of ordinal utility functions. This utility functions are ordinal because the only non-arbitrary feature of the numbers is their order. Magnitudes, sums and differences are arbitrary. A rational person, which always chooses the most preferred option, will be a utility maximiser. According to Hausman (2008: 236) “A utility function is just an assignment of numbers to alternatives in a way that indicates preference. ‘Maximizing utility’ is simply doing what one most prefers. Utility is not itself an object of preference”. The term utility, although inherited from utilitarianism, does not imply any sensation or feeling of pleasure, but rather refers to an index of preference. It is a concept that connects preferences to choices. Utility theory says nothing about what we should prefer. It simply says that whatever we prefer we must rank all the alternatives according to some criteria (transitivity, context independence) and no alternative should be ranked above the option we choose. Since rationality appears to be a normative notion, because saying what rationality is, is saying how one ought to be; then utility theory is a normative theory of how people ought to choose and prefer. It may also be a positive theory if we claim people behave in the sense described, which is what happens, for example, in consumer theory. In accordance with David Hume’s idea of reason as a slave of the passions, utility theory is an instrument which tells us how to satisfy our desires in the best possible way. No kind of explanation is given to why we have our desires, they’re taken as given constraints in a choice situation. But how then can economists know people’s preferences?

2. Revealed Preferences

To get to know people’s preferences it is always possible to ask them, in a given situation, what they prefer, but since this approach has its drawbacks- people may respond in a strategic manner, or it is too costly to get this information- economists have come up with an alternative method of knowing preferences. In the 1930’s, a period in which logical positivism had great influence on
economics, Paul Samuelson tried to eliminate the reliance on a subjective notion of preferences out of economics. Samuelson showed that if choices among bundles are consistent, then a complete and transitive preference ranking can be constructed from the choices (Hausman 1996: 19). Preferences are taken as revealed by the agent’s choices, and then become regarded as empirical observations. According to Hausman (1996: 19) “If I choose option x, when I might have chosen option y instead, then option x is revealed to be preferred to option y.” Choices among bundles are consistent if they satisfy the ‘weak axiom of revealed preference’ (WARP), which states that, if \( x \) is revealed to be preferred to \( y \), then \( y \) must not be revealed to be preferred to \( x \). Revealed preference is sometimes seen as a simplification of the theory of rationality. An agent A is rational if its choices satisfy WARP. Since A never chooses \( y \) when \( x \) is available, completeness and transitivity (the requirements of rationality) follow. This simplification is problematic, as we shall see in chapter 4 where some objections that apply to revealed preferences, as well as to the above presented conception of rationality, will be discussed.

3. Rationality and Individualism

The theory of rationality so far presented is a formal theory, insofar as rationality lies in the structure or form of choice and preferences, not in the content of what is preferred or chosen (Hausman 2008: 235). With this theory we can only assert that individuals are rational, or not, which merely means that their actions are determined by their rational (complete and transitive) preferences. Preferences here provide reasons and cause individuals to choose in a certain way. Without knowing the content of these preferences very little can be said about how people will choose. But economists also offer generalizations concerning what people prefer: “The most important of these generalizations is that people are materially self-interested, that they prefer more commodities to fewer, more wealth to less” (Hausman 2008: 236). With the addition of these generalizations it is possible to say something more about people’s choices. In chapter 2 we’ll explore further how economics is committed to ethical individualism. Rationality also comes in interplay with the methodological approach of economics, which subscribes a view of explanatory individualism where the fundamental explanatory principles should concern preferences, beliefs and choices of individual human beings. When econo-

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6. Recall also what was said about non-satiation in the Introduction.
mists try to explain the consequences of social entities and facts, they assume that those consequences are important only insofar as they are mediated by the preferences, beliefs and choices of individuals (Hausman 2008: 235). We can see here that these principles are the central components of rationality theory. Subscribing both the view that individuals are rational and the methodological approach that what matters are preferences, beliefs and choices of individuals, we get that the central explanatory principles of economics are principles of rational individual choice (Hausman 2008: 235). Rational theory can be seen as a theory of the central explanatory principles of economics. In the next chapter we’ll see how from a normative theory of rationality emerges a moral theory of welfare- Welfare Economics.

Chapter 2- Welfare Economics

Welfare Economics takes well-being to be the satisfaction of preferences. This theory of welfare arises, in economics, from the theory of rationality.

1. From Rationality to a Theory of Welfare

In Economics both the theory of consumer choice and the theory of the firm (central topics in microeconomics) identify both consumer and producers’ actions with rationality. The theory of rationality is simply taken to be the theory of actual choice, explaining both the way agents should and do act. Though rationality is a normative notion, it is not a moral notion. Rationality doesn’t say anything about the content of individual preferences- what one ought rationally to do need not coincide with what one ought morally to do (Hausman & McPherson 2006: 64). But, according to Hausman & McPherson (2006, ch.5), it is possible to derive mainstream normative economics from the theory of rationality adding some components of positive economics. Starting with the theory of rationality we add the assumption that individuals are exclusively self-interested (as we sketched in chapter 1), and the assumption that they have perfect knowledge7. At this point we get that individuals (self-interested and with perfect knowledge) prefer x to y if and only if x is in fact better for them- "one can identify how well-off an individual is with how well satisfied an individual's preferences are" (Hausman & McPherson 2006: 64). Self-interest makes in-

7. They know the consequences of all the alternatives they face.
dividual choice self-regarding, while perfect knowledge assures that what is chosen is what is in fact better, comparing the alternatives. Normative economics thus identifies welfare with preference satisfaction. All it needs more is one “innocuous moral principle of minimal benevolence: other things being equal, it is a morally good thing if people are better-off.” (Hausman 2006: 65). It is important to notice the unrealistic “other things being equal”\(^8\) clause, because it is seldom possible to make people better-off leaving all the rest untouched. From this results that the main issue of normative economics is the extent to which preferences are satisfied. The concepts of “Pareto optimum” (or efficiency) and “Pareto improvement” are important in this regard. These concepts enable economists to say something more substantive about welfare.

2. Pareto optimum and Pareto improvement

An economic state R is a Pareto improvement over an economic state S if and only if nobody prefers S to R and at least one person prefers R to S. An economic state of affairs R is Pareto “efficient” or “optimum” if and only if there are no Pareto improvements over R (Hausman 1996: 60). More simply, a Pareto improvement is a change that makes some people better-off without making anyone worse-off. A Pareto optimum or efficient allocation is a state of affairs in which it is not possible to improve one person’s situation without worsening someone’s condition. This analysis of welfare based on Pareto concepts is linked with rationality through preferences, as for there to be a Pareto improvement it is necessary that individuals have preference rankings (completeness condition of rationality). The fact that, according to Pareto criteria, improvements in welfare can only be possible when no one’s situation gets worse, results that there aren’t many real-world situations where there can be an improvement. If we have a state of affairs in which millions of people are starving, but there’s no way to make them better-off without making some rich person worse-off, no matter how slightly, then we are in a Pareto optimum situation (Hausman & McPherson 2006: 65). Though it doesn’t sacrifice the welfare of one person for the welfare of another, Pareto criteria aren’t of much use in most situations. From the notions of Pareto improvement and Pareto optimum economists have developed two “theorems of welfare”.

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8. Frequently called \textit{ceteris paribus} clause.
3. Two Theorems of Welfare

The first theorem of welfare states that: “the allocation resulting from any perfectly competitive equilibrium among self-interested agents is Pareto optimal” (Hausman & McPherson 2006: 66). A perfectly competitive equilibrium requires four conditions: 1- no interdependencies among people’s utility functions; 2- markets for all goods and services; 3- no barriers to entry or exit from the market; 4- so many traders in every market that no one can influence prices. A perfect competitive equilibrium obtains when there is perfect competition and demand equals supply in every market (Hausman & McPherson 2006: 66). Again, this theorem doesn’t help us much because perfect competition situations are near impossible- for example, there are some markets in which there can only be one producer, the so called natural monopolies. But it helps to explain why economists defend the ideal of perfect competition. If every perfectly competitive equilibrium is a Pareto optimal situation, and hence eventually morally desirable, one should promote the existence of perfect competition and avoid the existence of market imperfections, such as government interventions through subsidies or price fixing (for example), on the basis that market imperfections by affecting competitive equilibria, produce a morally undesirable outcome.

Another defence of perfect competition comes from the second welfare theorem. It states that “all Pareto optima can be obtained as competitive equilibria from the ‘right’ initial distribution of endowments.” (Hausman & McPherson 2006: 66). Simply this means that other concerns such as distributional justice may be solved through market interactions in perfect competition. One can achieve any desired Pareto optimum by first redistributing the resources that individuals bring to their market interactions and then let them trade freely. Perfect competition is thus morally ideal, because after having adjusted initial holdings, it allows to deal with concerns about justice. But as

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9. These theorems have a mathematical demonstration which we will not present here.
10. This implies the inexistence of externalities. Externalities occur when in producing one good some benefit or prejudice is made to other agents, as a by-product of the production process. For example, a factory producing clothes may end up dumping pollution on a river. Pollution is an externality because it inputs costs on other agents, which aren’t account for by the producer- the factory. In perfect competition there wouldn’t be externalities because there would be a market for every externality.
11. For example, water distribution and electricity transmission are natural monopolies, because the high costs of infrastructures and barriers to entry in the market make it only suitable, in practice, for one producer.
Hausman & McPherson (2006: 67) point, this conclusion does not follow in the case where there are other moral constraints besides justice- for example, if one held on moral grounds that some things shouldn’t be marketed, such as body parts. Another relevant problem is the political difficulties inherent in redistributing the initial endowments. In Chapter 5 we’ll provide a deeper analysis of these theorems. With Pareto criteria and the two welfare theorems we still have a very narrow theory of welfare, in terms of applicability to real world situations. Economists have developed a way by which they can greatly increase the scope of problems addressed: Cost-benefit analysis.

4. Kaldor-Hicks criterion and Cost benefit analysis

Another way through which economists have extended the scope of the Pareto concepts is through the idea of potential Pareto improvements. The idea was developed by Kaldor and Hicks and later also became known as the Kaldor-Hicks criterion. A state of affairs “X is a potential Pareto improvement over Y if there is some way of redistributing the goods available in X that makes X an actual Pareto improvement over Y.” (Hausman 2008:244). An example will be of use here: Imagine a situation where an economy produces 10 units of goods, which are distributed by agent A, who gets 6 units of x, and agent B, who gets 4 units of x. Suppose a new policy would make agent A have 9 units of x, while agent B would get 3 units of x. According to Pareto criteria this policy wouldn’t be approved because B would be made worse-off. But, this policy although making B worse-off, increases total production of x from 10 units to 12 units- there is, according to Kaldor and Hicks an increase in economic efficiency- the capacity of the economy to satisfy preferences has increased (Hausman & McPherson 2006: 144). In the view of Kaldor and Hicks economists don’t have to make moral judgments on economic distribution. “Economists should be concerned to enlarge the pie and should leave its division to politicians and moralists” (Hausman & McPherson 2006: 145). Here enters the concept of potential Pareto improvement. In the example, the situation resulting from the new policy, where 12 units of x are produced, is a potential Pareto improvement, because it would be possible to redistribute one unit from agent A to agent B (A would get 8 units of x, and B 4 units) and achieve an actual Pareto improvement. The notion of Pareto improvement is also seen in terms of a “compensation”: “If X is a potential improvement over Y, then it is possible for the winners in a change from Y to X to compensate the losers” (Hausman & McPherson 2006: 145).
it would be advantageous for A to give between 1 and 3 units of \( x \) to B so that the policy is approved and a Pareto improvement occurs. Economics operationalizes the compensation through the concept of willingness to pay: “If the amount that winners would be willing to pay to bring about a policy is larger than the amount losers would need to be compensated to accept the policy, then the policy is a potential Pareto improvement over the status quo, and the policy brings about a more efficient state of affairs.” (Hausman 2008: 244; 2006: 145). The notion of potential Pareto improvement is essential to cost-benefit analysis. According to this method of analysis, “among eligible policies (which satisfy legal and moral constraints), one should, other things being equal, employ the one with the largest net benefit.” (Hausman 2013, chp. 6.2). The largest net benefit (benefits minus costs) occurs when there is a potential Pareto improvement. This doesn’t require that the compensation is actually paid to the losers. In economists’ minds, concerns about justice or beneficence shouldn’t be handled by economics. Increasing efficiency is the main goal because it allows for a better satisfaction of preferences (Hausman & McPherson 2006: 146). Cost-benefit analysis is highly controversial, even within economists. In chapter 5 we will address some of the critics and problems it faces.

5. Interpersonal comparisons of utility

In the beginning of the twentieth century economists argued that overall welfare is maximized by equalizing incomes as much as is consistent with retaining incentives to produce (Hausman & McPherson 2006: 104). They argued that extra 100$ would increase more the well-being of someone with an income of 5 000$ than it would increase the well-being of someone with an income of 50 000$. This argument, which seems almost common sense, relies on the capacity of making interpersonal comparisons between the amount that a hundred dollars contribute to the well-being of different people. Economists at the time relied on substantive notions of well-being, such as wealth or happiness. After the 1930’s (recall point 3 in the Introduction), when economics strived to be a value-free science, most economists shifted to a vision of well-being as the satisfaction of preferences, because, as we’ve seen, it can be constructed from the theory of rationality with the addition of what were seen as ‘less compromising’ ethical assumptions. With a vision of well-being as preference satisfaction, to compare well-being is to compare the extent to which preferences are satisfied. This implies that the most relevant perspective for assessing if one is better-off is one’s self judgment. According to Hausman (1996: 58), one im-
plication of this is that it aggravates the problem of interpersonal utility comparisons. Economists can no longer say that equalizing incomes lead to welfare maximization, because, with the preference satisfaction view of welfare we cannot compare whether the rich will have their preferences better satisfied with an extra 100$ than the poor. First, as we saw in chapter 1, utility functions are ordinal. This means that utility is just a preference ranking. Adding the utility functions of two or more individuals to see whether good x or y would better satisfy preferences would be totally meaningless. To compare utility, we would need to have cardinal utility functions. Second, even if it would be possible to formulate cardinal utility functions, which seems in practice difficult, because we would need to have some way of capturing the extent to which individual preferences are satisfied, another difficulty could be what Hausman (2008: 240) points out as the problem of making sense of such comparisons. One can see why economists, wanting to avoid value discussions abandoned interpersonal utility comparisons. In chapter 4 the issues of interpersonal comparisons of utility and Daniel Hausman’s (1995) view on them will be further explored. Let’s just add for now that the topic of interpersonal comparisons of utility is what differentiates welfare economics from a utilitarian view of welfare. According to Amartya Sen, Pareto optimality would be the natural surviving criterion when one carries the utilitarian logic as far as possible without making interpersonal comparisons of utility (Sen 1987: 38).

Chapter 3- Ethics and Welfare Economics

In the previous chapters we got in touch with the central topics of welfare economics. The objective of this chapter is a double one. First it briefly reviews some perspectives on the concept of well-being in ethics, and second, analyses welfare economics in light of those discussions. With Sumner (1996) we will assume the concept of ‘welfare’ (the condition of faring well) to mean roughly the same as ‘well-being’.

1. The concept of Well-being

According to Crisp (2017) the concept of well-being is most commonly used in philosophy to describe what is the ultimate good for a person, i.e., what is desirable not as a means to something else (non-instrumentally), but by itself. Philosophers have developed theories about what is this ultimate good and what are its constitu-
The Ethics behind Welfare Economics

ents. It is common in contemporary ethics to distinguish between hedonistic theories, desire theories and objective list theories.

1.1 Hedonism

Hedonists believe that pleasure and pain are the only fundamental components of well-being (Bradley 2015: 13). A hedonist faces the challenges of answering what is pleasure and pain and why should they be identified with the ultimate good. Following Bradley (2015, ch.2) on the topic of hedonism, there are three views on the nature of pleasure. One view asserts that pleasure is a **distinctive kind of feeling**, that can result from doing a myriad of things like eating strawberries or driving a car. Another view is the **desire view** in which pleasure is identified with sensations we want to continue experiencing, even though they may be completely different from one another. Others defend an **attitudinal view** in which pleasure is an attitude directed at some fact or object. Pleasure and pains are assumed to have an intensity and a duration. The more intense and durable a pleasure is, the better it is. It is also assumed that pleasures and pains can be weighed against one another, i.e., there is some amount of pleasure that counterbalances some amount of pain. However, what these amounts are, precisely, and how to measure them is not a settled question. For the hedonist, how good an experience is, is equal to the amount of pleasure in it. It is plausible to assume that pleasure and pain provide reasons for acting. The fact that someone is in pain seems to give us a reason, **prima facie**, to make that pain stop. Whereas it seems plausible, **prima facie**, to promote actions that will be pleasurable to others. We also seem to think that pleasure is good for itself, and not as a means to something else, so it seems likely that pleasure must be among the constituents of well-being (Bradley 2015: 20).

In choosing between options the hedonist will choose the one that contains more pleasure for him. On simpler views of hedonism, no restriction is imposed on the objects that provide pleasure. This feature is called **non-elitism**. This makes these simpler views of hedonism subject to the critic that people may get pleasure from doing immoral actions, such as skinning cats alive, or consuming hard drugs. A solution is to abandon the non-elitism feature and defend a qualified version of hedonism (such as J.S. Mill’s hedonism), where pleasures differ not only in intensity and duration, but also in quality. In a qualified theory of hedonism immoral pleasures would
be classified as inferior pleasures and one would be better choosing superior pleasures. But then comes the problem of finding adequate criteria to distinguish between lower and higher pleasures. Another important critic of hedonism is Robert Nozick’s experience machine, which implies, according to hedonism, that people with their brains hooked to an experience machine which makes people live a virtual (and non-distinguishable from reality) life where they have the most intense long-lasting pleasures will be better-off. The thought of being better-off in such a machine is opposed by many philosophers. But this opposition seems to reveal that pleasure isn’t the only thing that is intrinsically good. In response to the experience machine there are some theories, in which what matters is not just the pleasure received from doing something, but also the fact the one has actually done something. This is the case of Fred Feldman’s truth-adjusted hedonism, which according to Bradley is better thought of as a hybrid theory (Bradley 2015: 30). Ethical hedonism shouldn’t be confused with psychological hedonism—the view that human beings always act so as to seek pleasure or avoid pain. Psychological hedonism is a psychological theory not an ethical one.

1.2 Desire theories

The view that what makes life go well, most fundamentally, is getting what we want is called the desire fulfilment view. Welfare economics can be seen as a version of this kind of theories. In fact, in his Stanford Encyclopedia of Philosophy entry on well-being, when presenting desire theories, Roger Crisp (2017, 4.2), recognizes in welfare economics a reason for the current dominance of desire theories. It is worth to reproduce here his words:

“Historically, however, the reason for the current dominance of desire theories lies in the emergence of welfare economics. Pleasure and pain are inside people’s heads and are also hard to measure—especially when we have to start weighing different people’s experiences against one another. So, economists began to see people’s well-being as consisting in the satisfaction of preferences or desires, the content of which could be revealed by the choices of their possessors. This made possible the ranking of preferences, the development of ‘utility functions’ for individuals, and methods for assessing the value of preference-satisfaction (using, for example, money as a standard).”
One important characteristic of desires is that they are attitudes not feelings. Attitudes are taken towards objects, while feelings are mental states. If we think welfare is the satisfaction (or fulfilling) of preferences (or desires), for the preference to be satisfied it is just for something in the world to happen according to my preference. Whereas in hedonism pleasure is normally a (subjective) feeling, thus hedonism being a subjective theory of welfare, desire theories are both subjective (because desires are subjective) and state-of-the-world theories, to use Sumner’s (1996: 113) terminology. The fact that the satisfaction of desires is achieved through a state-of-the-world occurring as we desire enables the desire theorist to escape the experience machine problem. The experience machine may give me the same feeling of pleasure I would get when satisfying my desire to write a great novel, but doesn’t actually satisfy this desire, because it is not a fact of the world that I wrote a great novel. Desires, like pleasures, are taken to have intensities and durations. There can be stronger or weaker desires, and persistent or immediate desires. Desires also have in common with pleasures the feature of non-elitism— it doesn’t matter what one desires, only if the person gets it or not. Desires can also be extrinsic— when a thing is desired in order to obtain something else— or intrinsic— when a thing is desired for itself. Only intrinsic desires seem to constitute well-being. The simpler version of the desire theory states that the intrinsic good is the fulfilment of desire. The intrinsic bad the frustration of desires. In such a theory to determine the value of a life we simply add the values of the desire fulfilment and frustration it contains. Such a view of well-being faces some problems. Like pleasures, it is possible that one has immoral desires— for example torturing animals, trivial desires— counting blades of grass in a garden, or base desires— someone who desires no more than playing video games. It seems odd that having these desires satisfied constitutes well-being. Another important problem is the case of adaptive preferences— where the society in which people live shapes their preferences in problematic ways. Individuals may adapt themselves to the restrictions or privations present in the society in which they live and stop desiring things that are forbidden or very unlikely to be fulfilled. Although what matters is the extent to which desires are fulfilled, if society deforms people’s desires, then desire-fulfilment seems to fail to account for what is welfare (Bradley 2015: 40). There also seems to be a difficulty in desire-fulfilment theories regard-
ing paradoxical desires. For example, the desire to have a bad life results in paradox. If the desire is fulfilled then the person according to these desires theories will have a better life. But what the person wanted is to have a bad life. So, in fulfilling the desire to have a bad life the person ends up getting a better life. There seems to be a paradox. There also seem to be other problems with desire theories. According to these theories if one of my desires is fulfilled but I don’t know about it, because I don’t end up receiving information confirming that my desire was fulfilled, it nonetheless makes me better-off. This seems rather odd. For example, in cases in which a person dies, but her desires stated while she was living get fulfilled, we have to assume that the person is made better-off, despite the fact that she’s dead. It looks strange that desires fulfilled in these conditions constitute welfare. Similarly, desires held in the past but that no longer are desired, if they get satisfied do they make one better-off? Philosophers have come to adapt their desire theories to accommodate some of these difficulties. One version of these desires theories (called informed desire) says that the desires that count are those the person would desire if she had perfect information about her future life plans, which enable the desire theorist to escape the problem of adaptive preferences and (maybe) the problem of immoral desires. Another solution involves saying that there are things which are objectively good to desire. Of course there is the problem of defining what is objectively good to desire and why, as there is the problem of explain why desires that would be taken under perfect information matter more for well-being.

1.3 Objective list theories

Objective list theories are theories which describe items constituting well-being. What unites all these things in a list is just the fact that they are constituents of well-being, however different they may be. Pleasure and desire-fulfilment may be on such lists, but there are many other candidates. The big question regarding such theories is what makes something go on the list. One of those theories, perfectionism, defends that what is good for a human is to develop those capacities which constitute human nature. Perfectionism is a species-relative theory: what is good for a human is different from what is good for a dog. The theory is objective because developing human capacities is good for you despite what you may think. A perfectionist has to account for his view on human nature and its constituent capacities. One traditional way of conceiving human nature is through its distinctive qualities. For instance, according to some views what distinguishes human beings is their rational capacity.
Thus, developing a rational capacity would be the good for a human. But there is no guarantee that humans are the only rational beings, and even if they are, it is unclear why distinctiveness should be so crucial (Bradley 2015: 51). Every objective theory that relies on human nature or on the essential features of humanity has the problem of explaining what characterizes human nature or its essential features, two far from settled problems, and the problem of explaining why what matters for well-being are these features. Some objective list theories are Pluralist theories of welfare. They identify things that are intrinsically good without appealing to human nature or essences. There is no deeper explanation to why things are on the list than the fact that they are good for us (Bradley 2015: 59). Virtue, Friendship, Freedom, Meaningfulness, Knowledge are some of the candidates in pluralist lists. One way to decide whether something is worth being on the list might be through tests such as the two lives test, for example (Bradley 2015: ch.5). The two lives test asks us to compare two lives that are identical in all respects except the fact that one contains feature F, a candidate feature for the objective list, while the other life doesn’t have F. If the life that contains F seems to be a better one, then F is a potential candidate for the list. There are other tests for the purpose of identifying potential candidates for the list, but, according to Bradley (2015: 61), these tests will often fail to resolve the problem of whether something is a component of well-being. Even if we manage to make such a list of good and bad things, there’s the problem of weighting the items on the list. How much of the good things is necessary to compensate one bad thing? All the good things count the same for well-being or some count more than others? It is difficult to answer these questions in a non-arbitrary way without providing a unifying reason for why a thing is good.

2. Welfare economics and welfare theories

Welfare economics, in which welfare is the satisfaction of preferences, is one version of a desire theory of welfare. Roughly the same critics and problems that apply to desire theories apply to welfare economics. In the previous chapter we saw that the theory of welfare in economics emerges from the theory of rationality with the addition of the assumptions that individuals are self-interested, have perfect information, and the principle of minimal benevolence (ceteris paribus it is a morally good thing if people are better-off). A welfare theory that results from this combination of ingredients is more similar to an informed desire theory than to a simple desire theory. Since people...
have perfect information they do in fact choose the option that makes them better-off. But it is debatable if this is enough to accommodate some problems. For example, the case of immoral, base and trivial desires. It seems odd that someone who is able to predict and compare the outcomes of all its potential choices, and always chooses the best option, would choose to count blades of grass, torture animals or play video games all day. But we can’t really know for sure. The choice depends on the person’s self-interest but that doesn’t automatically exclude the possibility that for some peculiar person the best thing to do is really to count blades of grass. For the economist, however, what matters is that the preference gets satisfied, even if the preference is for counting blades of grass, because what is morally desirable is that one’s preference is satisfied, regardless of the fact that the preference seems immoral or not. The seeming immorality of a preference can be a misconception on what welfare is. The case for adaptive preferences looks more complicated. It seems plausible that people adapt their preferences to the material conditions they experience or to what is legally possible to do in the society in which they live. Someone choosing under perfect information will be able to calculate the probability of success of actually doing something that seems very unlikely given the material conditions in which she lives, or the probability and costs of getting caught doing something illegal. It may be that after all these calculations the person isn’t required to adapt so much because she can see, after all the calculus, alternative ways of satisfying preferences which seem impossible. But even if people had this astounding capacity of calculating the alternatives, someone who lives in a society with more freedom and where minimum living conditions are guaranteed would seem to be better than one person who lives in a society where these things lack, because, even if both could satisfy the same preferences, the one living in the more free and materially better society would probably satisfy these preferences more easily, without so much effort or probability of failure. This seems to count for welfare. Perfect information doesn’t save the person in a more restrictive society from being worse-off. One of the assumptions on choice is that people always choose the most preferred option. It can be that the most preferred option isn’t so good, if other things which constrain what is feasible to do, like rights, freedom and material conditions are very restrictive. This seems to be the line of argument of Amartya Sen (1987). When we consider that people in fact don’t have perfect infor-
information and great calculus capacities things get worse. When they have perfect information, individuals know what is better for them. Without it they may be overly influenced by things like peer-pressure, marketing and publicity, television and films, and end up choosing something which in the end doesn't make them feel better-off. In such cases choosing the most preferred option isn’t what makes one better-off. Of course, this only matters if feeling better-off is thought to be important to actually being better-off.

In the case of preferences which we had but no longer have that get satisfied, if we don’t drop the perfect information assumption, then it seems strange that someone stopped desiring what she choose under perfect information- which is what is in fact better for her. If we drop perfect information then the same problem arises. People have their (past) preferences satisfied but don’t feel better-off. The same applies for preferences that get satisfied but we ignore it.

Faced with all these problems of welfare as the satisfaction of preferences the economist can claim that his interest is in making economics not ethics. He is not interested in explaining what makes people better-off in all conditions and cases, but just in those situations that are within the object of study of economics. Albeit this object of study is not very well defined in terms of its boundaries, there are nonetheless situations which seem to be the typical object of analysis of economics, like situations involving market transactions, investments, resources management, to say a few. Maybe welfare as the satisfaction of preferences is a very plausible view on what people engaged in such situations aim at. Economics isn’t concerned about the way one should live his life - if becoming an animal torture, a grass counter, or playing video games all day- but in explaining people’s motivations to act in market related issues. Although this is a possible defence for the economist, there are still problems when market situations have serious impacts on people’s lives. Market situations can be very different from each other. The social repercussions of a decision to buy groceries at a supermarket are completely different from the repercussions of a government’s decision on its health policy. In chapter 5 we’ll deal more deeply with questions like these.

In the following chapters of Part II we’ll see some problems with the way economics portrays rationality, and welfare, whether its welfare view is limited to market situations or not.

\[\text{12. The work of Kahneman and Tversky is paradigmatic on this topic.}\]
Part II- A Philosophical critique of Welfare Economics

Chapter 4- A critique of rationality

The theory of welfare in economics emerges, in part, from the theory of rationality. To be rational is to have rational preferences and always choose the most preferred option. It is assumed that individuals reveal their preferences in their choice decisions. Utility in this context is simply an index of preferences, not a feeling of satisfaction, or happiness.

1. Problems with rationality

One of the main problems with the theory of rationality is that if it is supposed to be a normative theory on how people should behave, then it seems to leave aside many actions that seem rational. On the other hand, if it is a descriptive theory on how people behave, then it is completely false. Evidence in experimental psychology shows that it is wrong to identify rationality with actual behaviour. The work of Kahneman and Tversky, Thaler, or Diener, to cite a few, shows that inconsistencies are very present in actual choice behaviour. In certain cases, people violate the axiom of transitivity and are influenced by such things as the way the alternatives are described. It was also shown that humans aren’t very competent at calculating probabilities in situations of risk, which makes them violate the axioms of expected utility theory.

If economic models rely on the assumption that people behave rationally, as some models do, then it is inevitable that some predictions will be off the mark. Theories of economics based on rational behaviour have to take into account this difference between predicted behaviour and actual behaviour. Although economists are aware of this and a new field of economics called behavioural economics emerged in trying to handle with these problems, it is not uncommon to see economic models based on the assumption of rationality. As a normative theory rationality seems too demanding. It doesn’t seem so far from rational that one person who has to choose among two alternatives is incapable of ranking them. For example, in the case where a person asks which of your two children do you prefer to die, it doesn’t seem irrational for someone to reply “I don’t know”. Yet being unable to rank preferences violates the axiom of completeness. Is it really a necessary condition of being rational? There are also other problems which seem to derive from the idea that preferences are revealed by choice, which we’ll see next. It is also important for economists to consider alternative theo-
ries of rationality such as Herbert Simon’s bounded rationality. According to Simon, for individuals to maximize utility would take them enormous amounts of time and effort. Suppose in deciding to buy a house one has to see all the available houses within the area a person wants to live before making a decision. It would take an enormous amount of time to complete this task, and probably when it would be finished more houses would be available for sale. Simon proposes that instead of maximizing utility, people should set an aspiration level and accept the first alternatives that meet their aspirations rather than seeking the best solution (Hausman & McPherson 2006:50). Although this model may be more difficult to operationalize mathematically, it can be more descriptively accurate.

2. Problems with revealed preference

The view that people’s preferences are revealed in their choice decisions faces serious objections. For instance, revealed preference seems to presuppose that the individual who made the decision is actually rational. For example, if the individual doesn’t always choose the most preferred option, then it can be false that the option he chose is the one that he prefers. Also, if the individual doesn’t have transitive preferences, revealed preference can provide mistaken conclusions. Using revealed preference seems to presuppose that actual behaviour is rational, which is probably false. Another problem is the fact that revealed preference doesn’t allow for changing tastes. An agent can prefer \( x \) to \( y \) and later become to prefer \( y \) to \( x \) because his tastes have changed. This isn’t abnormal for most people to do, and it’s odd that it should be considered a violation of rationality. Yet it constitutes a violation of WARP (recall Chapter 1). In his book, *Welfare, Happiness & Ethics*, Sumner (1996) criticizes the view of welfare as the satisfaction of revealed preferences. In his view, “even if preference is infallibly manifested in choice, there can be no justification for excluding non-market choices from a general account of welfare” (p.118). Things like friendship and loyalty can be important for welfare, but there’s no way they can be revealed by market choices. Also, some things may be provided to us by a market or not, such as education or health care. It isn’t reasonable that these things stop counting for welfare when they stop being provided by markets. This critic directly attacks welfare economics’ possibility of providing an account for general welfare, but, as I argued in the end of chapter 3, economist’s can claim that their theory is a par-
tial theory of welfare, one that applies only to market related issues. Another point Sumner argues is that preferences revealed in choice are only a small part of all the preferences a person has. Choices differ from preference, because choosing between two alternatives presupposes the availability of both, while having a preference between them doesn’t. If we limit ourselves to preferences revealed through choice we’ll have an incomplete view on what are people’s preferences. He argues: “If my preferences are to connect in some important way with my welfare, then it seems reasonable to think that all of them should count, not just those I have had the opportunity to reveal in choice” (1996: 119). Sumner also points out that revealed preference theory is based on an ambiguous use of the concept of preference. The notion of preference can be understood in two ways: one looking to attitudes, the other to choices. In the attitudinal sense “what I prefer is what I like best (for its own sake) or find most agreeable.” (1996: 120). In the behavioural sense what I prefer is just what I choose for whatever reason. According to Sumner “It is only in the attitudinal sense that preference can be plausibly connected with welfare, but in this sense there is no tight connection between preference and choice. The fact that I choose x rather than y does not show that I expect a higher personal payoff from it, since my choice may be motivated by other considerations such as altruism or a sense of obligation” (1996: 120). In the attitudinal sense, which is the sense that matters for welfare, counter-preferential choices are possible. Economists make a mistake when they tie preference and choice through the behavioural sense of preferences, and then tie preferences to welfare through the attitudinal sense. In the end the theory is flawed because the preferences that matter for welfare aren’t always revealed through choice. Sen (1977) makes a similar point. Preferences revealed in choice may be the result of behaviour based on commitment. This kind of behaviour can be misrepresented as a preference, using revealed preference. The problem here seems to be that revealed preference theory appears to presuppose only actions based on self-interest, in which what is chosen depends only on the individual’s interest, thus failing to account for other reasons to act. These problems with revealed preference are serious because of the central position it occupies within economics. It is from revealed preferences that economists deduce consumer’s utility functions. If preferences aren’t being adequately captured by this theory, we’ll have deficient utility func-

13. For example, commitment to a certain promise, or deontological principle.
tions, and thus problems with economic models using these functions.

3. Some remarks on interpersonal comparisons of utility

As utility came to be defined as a ranking of preferences in neoclassical economics, comparisons of utility were abandoned, because it would be difficult to compare between individuals’ rankings of preference. These rankings tell us the order of preference for the alternatives an individual has. Utility is ordinal— the numbers assigned to the alternatives are relevant only insofar as they serve to order the alternatives. Let’s imagine a simple situation where two individuals John and Joe have to choose between three options, option A, option B and option C. Let’s suppose John and Joe are rational and their preference rankings can be represented by tables 1 and 2 below. For John’s to maximize utility is for a state-of-the-world where John has B to occur, while in Joe’s case utility is maximized in a state-of-the-world where Joe has A occurs.

<table>
<thead>
<tr>
<th>John’s Preference Ranking</th>
<th>Object of preference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1&lt;sup&gt;st&lt;/sup&gt;</td>
<td>B</td>
</tr>
<tr>
<td>2&lt;sup&gt;nd&lt;/sup&gt;</td>
<td>C</td>
</tr>
<tr>
<td>3&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>A</td>
</tr>
</tbody>
</table>

Table 1- John’s Utility Function

<table>
<thead>
<tr>
<th>Joe’s Preference Ranking</th>
<th>Object of preference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1&lt;sup&gt;st&lt;/sup&gt;</td>
<td>A</td>
</tr>
<tr>
<td>2&lt;sup&gt;nd&lt;/sup&gt;</td>
<td>B</td>
</tr>
<tr>
<td>3&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>C</td>
</tr>
</tbody>
</table>

Table 2- Joe’s Utility Function

How is one to compare between John and Joe’s preference rank-

14. The tables don’t show utility numbers assigned to each option, but the order of the preferences. Numbers were omitted because what is relevant for the argument is just the order of preferences that the numbers reflect, not the numbers themselves which would be arbitrary.
ing? Suppose both individuals have their highest ranked preference satisfied. How can we say which of them is better-off? How to compare between John-with-B and Joe-with-A? We would need something to measure the intensity of preference and to assume that individuals are affected in the same way by these intensities. We would need a subjective notion. Of course, we could find a proxy for those subjective notions. For example, we could compare the amount of money John is willing to pay to have B and the amount Joe is willing to pay to have A. Maybe this willingness to pay reflects the intensity of preferences. But this is still problematic. If John is much richer than Joe he can have a higher willingness to pay for B than Joe’s willingness to pay for A, even if he prefers less B than the amount Joe prefers A. Or maybe for John the difference in intensity between B and C (2nd most preferred option) is so big that he is willing to pay much more for B, than Joe for A, which only prefers A very slightly to B and because of that isn’t willing to pay much more to have A than to have B (which we suppose is cheaper). But in doing this step we would be shifting the concept of utility to a feeling of satisfaction, or pleasure, much like a hedonist would conceive utility. If we maintain that utility is a ranking of preferences, to compare utility will be something different. Following Hausman (1995: 476), at first glance, we can compare ordinal utility levels, by comparing the extent to which two persons preferences are satisfied. The extent to which one’s preferences are satisfied is greater just in case one is further up in her preference ordering. For example, John is better-off with some option x than Joe with some option y if and only if x stands higher in John’s preference ranking than y stands in Joe’s preference ranking. In this case we are comparing individuals based on their location on their preference ranking. But how can we say that John who satisfied his 10th ranked preference is better-off than Joe who satisfied his 15th ranked preference? In some cases, when there are large, or infinite (in the case of lotteries), numbers of alternatives it would be difficult to know the exact position in the ranking in which one person is. Hausman also points out that the position on the ranking depends on the number of alternatives considered, which will depend on moral irrelevant factors such as a person’s imagination. Hausman (1995: 477) analyses another method of making interpersonal comparisons, the so called “judgments of extended sympathy". With these judgments we look for ways of comparing person-state pairs- John-with-x, and Joe-with-y- and decide whether it is better to be
John-with-x or Joe-with-y. A problem with this kind of judgments is that people may prefer to be John-with-x than Joe-with-y for reasons which aren’t related to welfare. People may also prefer John-with-x because they think it is better for John to have x, than for Joe to have y, but in this case the decisions is being made according to someone else’s preferences, why should they matter to know if John is better-off than Joe? We have to look for an impersonal way to measure which one is better-off. But according to Hausman it isn’t altogether clear how to arrive at such measure. For this author interpersonal comparisons of ordinal utility are impossible. In his view this is reason enough to deny the view that welfare is the satisfaction of preferences (Hausman 1995: 485-486). We won’t discuss more deeply the question of interpersonal comparisons of utility. But it is important to note here one premise in Hausman’s argument: “If a conception of well-being does not permit one to make interpersonal comparisons in an acceptable way, then that conception of well-being is itself unacceptable” (1995: 474), which doesn’t seem to have been in economists’ minds when they advocated the view that interpersonal comparisons of utility are meaningless. This premise seems plausible if one is to account for a general theory of welfare. But, again, if economists are limiting themselves to a partial theory of welfare to apply in market related issues, maybe it can be acceptable to have a theory which doesn’t make interpersonal comparisons.

Chapter 5- A critique of Welfare Economics

In this section we’ll point some critiques of what was presented in Chapter 2 of Part I, particularly the inadequacy of Pareto criteria, the conclusions of welfare theorems based on them, and the controversial cost-benefit analysis approach to decision making.

1. Pareto criteria and welfare theorems

We saw in Chapter 2 that the concepts of Pareto optimum and Pareto improvement result from the theory of rationality with the addition of two assumptions, one regarding self-interest and one regarding perfect information, and one principle of moral benevolence. One striking feature of the Pareto optimum is that it is very limited in terms of its prescriptions. Recall that any potential change that could
bring about an overall increase in welfare, but makes one person worse-off, no matter how slightly, is not morally desirable according to this criterion. In real world, situations that result in Pareto improvements are very rare. It is often the case that someone is made worse from a policy or another agent’s decision, even if not directly. Such a view on what is morally desirable seems too weak. If it is what results from trying to have moral criteria without making interpersonal comparisons, then it is one more reason to defend the need for interpersonal comparisons. Some presuppositions seem to underlie these criteria. First, as is obvious from the fact that the criteria derive from rationality, it seems to demand that agents are rational. If they weren’t capable of ranking alternatives, or were inconsistent in doing so, or didn’t choose the most preferred option, it wouldn’t be possible to say that someone is made worse or better-off. Second, and tied to the rationality condition, it seems to require that agents are capable of calculating the outcomes of the alternatives they face, which in cases of risk and uncertainty isn’t very likely. Third, it seems to demand intrapersonal comparisons of utility. Economists don’t seem aware of such problems, but for an agent to say that he is better or worse-off in a change from situation 1 to situation 2 it is necessary that he compares what it would be like for him to be in situation 1 with what it would be like for him to be in situation 2. The comparison is only relevant if that ‘him’ is the same person. But, for example, if situation 2 drastically changes the person living it, that he no longer is the same person, then the comparison may be no less problematic than comparing the welfare of two different persons. A problem with these criteria is also what they leave aside. Concerns for distributive justice aren’t taken into account. We can have many Pareto improvements occurring that result in ever higher inequality because the improvements are brought about by the rich becoming richer (Sen 1987). Regarding the two welfare theorems, they tie the Pareto’s ‘moral desirability’ feature to the defence of market mechanisms, because these market mechanisms can bring about Pareto optimum outcomes, thus, morally desirable outcomes. But if the criterion for moral desirability is the modest Pareto optimum there appears to be no good reason in favour of these mechanisms. The first theorem states that the allocation resulting from any perfectly competitive equilibrium among self-interested agents is Pareto optimal. We already commented in Chapter 2 that perfect competition situations are practically impossible. Nonetheless the theorem may work as a defence for approximations to perfectly competitive markets. But
if we should promote perfectly competitive markets in order to have Pareto optimal equilibria then this doesn’t seem such a good reason to promote perfectly competitive markets. Also, according to Hausman (2008: 242), Lipsey and Lancaster established that the efficiency of perfect competition does not justify attempts to eliminate particular impediments to actual competition. The argument is related to the fact that it is hard to know a priori, if attempts to eliminate market imperfections will improve or diminish economic efficiency. So, as a defence of perfect competition, the first theorem doesn’t seem particularly relevant.

The second theorem states that from the ‘right’ initial distribution of endowments all Pareto optima can be obtained as competitive equilibria. The fact that all Pareto optima can be obtained is more interesting. Maybe we can combine other concerns with the goal of achieving Pareto optima. For example, we can choose to achieve the Pareto optima that guarantees more distributive justice, or more freedom. Although this seems more appealing, it stills requires an idealized perfectly competitive market to bring it about. But even if it was possible such a market, obtaining the ‘right’ initial distribution of endowments would require large quantities of information on all people’s endowments, and a very strong political force to bring it about (Sen 1987: 35).

As Hausman puts it: “Who cares whether a perfectly competitive economy, which is not possible, is Pareto efficient and whether such an impossible economy could, as a consequence of an infeasible initial distribution, also result in an equitable distribution of income?”. The problem is that mainstream economists care. “Whether opposed to government intervention in the economy or in favour of it, mainstream economists typically treat perfect competitive equilibrium as a benchmark and a moral ideal.” (2008: 242-243). If the reason for defending perfect competition is Pareto optimality, or efficiency, then their argument completely lacks moral relevance.

2. Problems with cost-benefit analysis

Cost-benefit analysis, which expands further the logic of Pareto criteria, is object of many controversies and problems. An entire thesis could be made on such a vast topic. In this point we’ll analyse some of its problems that seem more flagrant. According to Wright (2015: 87) cost-benefit analysis can be seen as a change to the economic theory of welfare: with cost-benefit analysis “it is now the capacity to satisfy preferences that counts, not the actual satisfaction of preferences”. It goes beyond Pareto criteria by allowing some...
to be worse-off, just as long as the winners gain more than what the losers lose. Cost-benefit analysis is the instrument used in many government policy decisions, so it is important that its problems are acknowledged. A serious problem in cost-benefit analysis is the compensation. Although it is theoretically possible to compensate losers it is usually complicated and difficult to implement. The losers may be politically weak, widely dispersed and difficult to identify. The harm to the losers may be also hard to identify. For example, not long ago the effects on air pollution on health weren’t so evident as they are today, which implies that decisions that didn’t take into account this costs to public health (because simply there has no evidence for it) underestimated their costs. Even if we require companies that polluted the air back then to compensate for these social costs, the persons affected by them may no longer exist, or even the companies may no longer exist. The fact is that today we are still affected by pollution emitted many years ago, when the social costs of pollution weren’t taken into account. The example above raises some issues relevant to cost-benefit analysis. First, how are we to account today for costs made to future generations? Even if we account for these costs in some way, if these costs are sufficient to alter the decisions that would be made, the persons living in the future will be different persons that those that would live had the decision not been altered. So, are we considering costs to people that will never exist? Should we value existence in some way? These are very important issues. Second, when dealing with social decisions, the agents who benefit from the decision will have an incentive to undervalue costs, when the costs don’t accrue to themselves. If decisions are to be taken according to the highest net benefit, undervaluing costs implies an overvalued net benefit, which may lead to wrong decisions. For example, some project that benefits an air polluting company may not be accepted if the amounts of pollution increase are too high. The company obviously has an incentive to under declare its pollution amounts. This problem is related to asymmetrical information- the company knows exactly its level of pollution emissions, while a government can only make faith on its declarations or send an assessing team. In the latter case the government incurs in costs for having this team. In sum, getting information on costs is sometimes not very easy and not costless. Another problem with cost-benefit analysis is that it compares willingness to pay rather than welfare gains and losses. The problem is that

16. This point was inspired by Derek Parfit’s Repugnant Conclusion.
The Ethics behind Welfare Economics

willingness to pay depends on a person’s wealth. The rich will show more willingness to pay for a policy that suits them than the poor, simply because they have more money. If the poor show less willingness to pay, the amount which they’ll have available to compensate the rich might not be enough to compensate them. So, the analysis seems to be biased towards the preference of the rich. Of course, a government concerned with distributive justice may force compensations to be paid, but in practice this may be difficult, as we discussed earlier. On the other hand, if governments fail to implement compensation, or simply don’t care about it, overtime the bias of cost-benefit analysis towards the preferences the rich may produce striking social inequalities. Neoclassical economists aren’t concerned about these issues, but politicians must be and should have serious concerns about using this method for policy. Two other problems are related with preferences. According to Hausman & McPherson (2006: 149-150) “social policy should not be based on the unreflective and unargued preferences that analysts deduce from people’s economic choices”. This point is similar to one of Sumner’s arguments against revealed preference analysed in Chapter 4. It is not possible to deduce all relevant preferences looking at choice. A preference for a more peaceful local community is hard to observe from market choices. Another problem is with preferences based of false beliefs: “when people have mistaken beliefs about the constitution of the exhaust from the factory down the road, their willingness to pay to avoid breathing it will be an unreliable indicator of their true preferences, let alone of the exhaust’s welfare consequences” (Hausman & McPherson 2006: 151). Faced with all these problems and some more which we didn’t deal with here, cost-benefit analysis should be used with caution, and it shouldn’t be the decisive factor in policy decisions. Its misguided use may have very serious consequences for society. It is important that its users acknowledge these problems, and that alternative methods are considered.

Concluding Remarks

From this long analysis of Welfare Economics and some of its problems a conclusion emerges. Economists are better-off defending that their theory of welfare is not a theory of the ultimate or intrinsic good, but a partial theory of welfare, one that pretends to explain what is good
for people in market related issues. This doesn’t save them from some problems when market situations are intertwined with ethical problems, such as distributive justice, as we’ve seen in the case of cost-benefit analysis. But recognising welfare economics as an incomplete or partial theory of welfare, can make room for other perspectives to be considered, even within economics. I believe that recognising the incompleteness of their welfare theory would make other methods of getting to know people’s preferences more accepted, which would be beneficial for economics: for instance, preferences can be revealed by public referendums, or public inquiries. These methods should complement revealed preference. Even restricting the object of study to market issues, other reasons for action, other than self-interest, or outcome calculation, should be considered, such has actions taken by commitment to some principle. Maybe preference revealed through choice is a good approximation to human behaviour in this kind of choice situations, but economists shouldn’t be blind to other possible explanations. It’s important also that economists recognise the fragilities of their defence of perfect competition, if that defence is to be based on the argument of economic efficiency qua Pareto optimum. Pareto criteria are very limited notions of moral desirability, to defend that distributive justice should be left to market mechanisms, based on these criteria, is certainly a fragile argument. Regarding rationality, it is important to consider alternative views such as Herbert Simon’s, for example. Rationality seems too demanding as normative notion and is probably false as a descriptive notion. It is also important that politicians and citizens, in general, are aware of some of these controversial features of economics. Economic justifications are many times used as political arguments by politicians, who ought to know the fragilities of the theory they’re applying. This is particularly relevant in what regards the widely used cost-benefit analysis.

References


The Ethics behind Welfare Economics

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