

May/June 2012 SB : @6: (6) (6 marks)

'Cardinal' Additive welfare function

$$W = U_a + U_b + \dots$$

W = level of community welfare

U_a & U_b = individual utilities

Individual utilities are assumed to be measurable on the same scale.

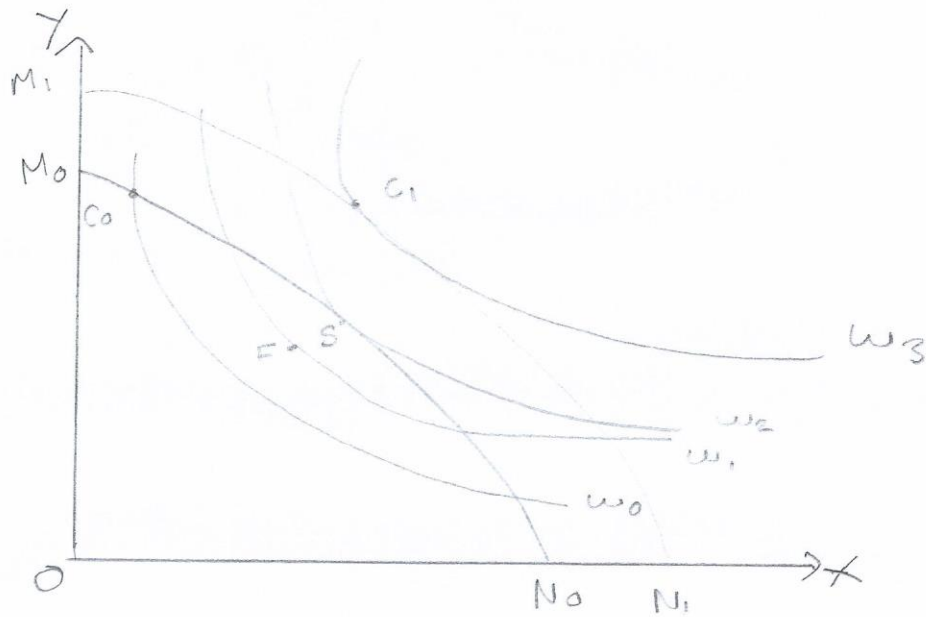
Assumptions

- individuals have identical utility functions which depend only on their income.
- U ~~dim~~ ↓ as Y ↑
- total amount of Y if fixed.

Limitations of assumptions:

- impossible to determine the validity of identical utility functions since utility cannot be measured objectively.
- difficult to prove that MU from an extra ΔY declines
- it is possible ^{that} total Y may decline as Y is redistributed since taxes & subsidies change people's incentive to work.

14 Oct / Nov 2012 SB : Q4 : (b) (10 marks)



Equity vs efficiency

- initial distribution of resources = C_0 .
allocative efficiency, top-level, Pareto optimal equilibrium.
- Social welfare = ω_0
- Redistributing resources $\rightarrow \uparrow$ social welfare
 $\rightarrow \omega_2$ point F.
- Resources now distributed more equally, BUT
point not an efficient allocation (inside PPC)
- conflict between equity & efficiency.
- Social welfare at a higher level -
therefore trade-off between equity &
efficiency.