

# CHAPTER 19

## MARKET SYSTEMS AND NORMATIVE CLAIMS

*Microeconomics in Context* (Goodwin, et al.), 1<sup>st</sup> Edition (Study Guide 2008)

### Chapter Summary

This final chapter brings together many of the themes previous chapters have explored throughout the book. It explains a powerful – and sometimes misleading – concept in standard economic theory, the idea of Pareto efficient outcomes. After studying this chapter, you will be able to explain the concept of Pareto efficiency as well as the intellectual history of the idea. You will also understand the normative and positive assumptions that underlie this concept and the some of the major policy-related conclusions that people have drawn from it.

This chapter also provides an overview of the different schools of economic thought that we have drawn on throughout this textbook, and explains the background to some of the arguments about “free trade” and “small government” that arise frequently in real-world economic debates.

### Objectives

After reading and reviewing this chapter, you should be able to:

1. Define the basic tenets of neoclassical economics.
2. List the assumptions used to support the “free market” argument.
3. Describe the principle of Pareto efficiency.
4. State the first fundamental theorem of welfare economics.
5. Describe the policy prescriptions of the simple mechanical model.
6. Describe the historical development of alternatives to neoclassical economics.
7. Briefly characterize varieties of economic thought, including institutionalist economics, social economics, Marxist economics, post-Keynesian economics, Austrian economics, ecological economics, and feminist economics.
8. Describe the limitations of the Pareto efficiency criterion for addressing intergenerational equity and the relationship between individuals and society.

### Key Terms

neoclassical economics  
first fundamental theorem of welfare economics  
new institutionalist economics  
institutionalist economics  
Marxist (radical) economics  
Austrian economics  
feminist economics

Pareto efficiency  
general equilibrium  
second-best theorem  
social (socio-) economics  
post-Keynesian economics  
ecological economics  
individualistic ethic

## Active Review Questions

### *Fill in the Blank*

1. The school of economics that takes the traditional model as its starting point is known as \_\_\_\_\_ economics.
2. A situation in which there is no way to make one person better off without making anyone else worse off is known as \_\_\_\_\_ efficiency.
3. According to the “first fundamental theorem of welfare economics,” a \_\_\_\_\_ economy will be \_\_\_\_\_ efficient.
4. A situation in which information flows are instantaneous and all prices and quantities are determined simultaneously is known as \_\_\_\_\_.
5. The school of economics that emphasizes the complex nature of organizations and the strong influence of habit on people’s behavior is known as \_\_\_\_\_ economics.
6. The normative judgment that only the preferences and choices of individuals carry ethical weight is known as the \_\_\_\_\_ ethic.
7. The school of economics that emphasizes the power that comes with the ownership and control of capital is known as \_\_\_\_\_ or radical economics.
8. Economists Lipsey and Lancaster demonstrated that if just one condition for full Pareto efficiency is not met, then the next best outcome can generally be reached only by departing from all of the other conditions. This insight is known as the \_\_\_\_\_ - \_\_\_\_\_ theorem.
9. A statement about how something *should* be done can be referred to as a \_\_\_\_\_ statement.
10. Concerns about \_\_\_\_\_ equity arise when we look at the possible effects of today’s economic decisions on the well-being of future generations.

### *True or False*

11. The statement “all economies should become socialist” is normative.
12. The neoclassical approach to economics has increasingly dominated teaching and economic scholarship since the 1930s.
13. In the pure neoclassical model, marginal thinking is assumed not to exist.

14. A concern with people's survival needs is very important in justifying the view that "free markets" are best.
15. Pareto efficiency requires relatively egalitarian distribution of resources as a precondition for utility maximization.
16. A situation is Pareto inefficient if there exists an option for change to which all parties would agree.
17. Market forces generally solve intergenerational equity problems if government interference is kept to a minimum.
18. Austrian economics embodies the principle of both ecological economics and feminist economics.
19. The term "contextual economics" is used synonymously with the term "institutionalist economics."

*Short Answer*

20. Briefly state the viewpoint that is sometimes referred to as a "neoliberal" position.

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21. "Market outcomes necessarily reflect only the interests of current market participants." Briefly explain the implications of this statement for intergenerational equity.

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22. The textbook states that the free market general equilibrium model is *precise*, but not necessarily *accurate*. Explain the difference between precision and accuracy, and illustrate this difference with an example.

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23. Briefly summarize the defining characteristics of institutionalist economics.

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**Problems**

1. Imagine a hypothetical two-person economy inhabited by two individuals, Joe and Antoine. Joe is very rich and has a high level of utility. Antoine is very poor and has a low level of utility. Joe's utility level is 500 utils. Antoine's utility level is 10 utils.

a. Suppose a different production situation in the economy would cause Joe's utility to rise to 550 utils and Antoine's utility to rise to 20 utils. Would changing to this new situation be justified by the Pareto efficiency standard? Why or why not?

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b. Suppose another production situation in the economy would cause Joe's utility to fall from 500 utils to 495 utils, while Antoine's utility would rise from 10 utils to 450 utils. Would changing to this new situation be justified by the Pareto efficiency standard? Why or why not?

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c. Suggest a possible reason why Joe might be willing to agree to the production change described in part (b), even though it decreases his utility slightly.

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**Self Test**

1. Which of the following is *not* an element of the stylized economic system that forms the basis for the basic neoclassical model?

- a. perfect information
  - b. perfect competition
  - c. rationality
  - d. the desires of future generations
  - e. production by firms
2. A Pareto efficient situation is one in which
- a. At least one person can be made better off without making anyone else worse off.
  - b. Everyone enjoys the maximum possible utility, as defined by that person, given global resource constraints.
  - c. There is no way to make one person better off without making another person worse off.
  - d. Utility levels can be compared across individuals.
  - e. All firms are able to make positive profits, due to market power.
3. Which of the following is *not* an assumption of the theory underlying “free market” thinking?
- a. All needs can be satisfied through market transactions.
  - b. There is perfect information.
  - c. People’s basic needs for food and clothing must be satisfied.
  - d. Markets are perfectly competitive.
  - e. Production technology is characterized by diminishing returns.
4. Which of the following is a normative statement?
- a. Capitalism should be adopted worldwide.
  - b. Capitalism exists in a variety of forms.
  - c. The economy includes both firms and households.
  - d. Perfect competition is an assumption of the neoclassical model.
  - e. Market power can lead to positive profits.
5. The “new utility theory” view of well-being holds that
- a. Utility can be compared across individuals.
  - b. Utility cannot be compared across individuals.
  - c. A poor person cannot be happier than a rich person.
  - d. Creating an egalitarian society is the primary goal of economic development.
  - e. Poverty and capabilities are the main focus of economic analysis.
6. The table below shows all possible options for allocating resources in a hypothetical two-person economy inhabited by Mary and Jodie. Based on the information given here, which scenario is Pareto efficient?

Scenario	Utility Level	
	Mary	Jodie
<b>A</b>	10	15
<b>B</b>	10	10
<b>C</b>	20	10
<b>D</b>	20	15
<b>E</b>	15	5

- a. A
- b. B
- c. C
- d. D
- e. E

7. Once again, assume that the information shown below shows all the possible options for resource allocation in a two-person economy. Which of the scenarios shown below is *not* Pareto efficient?

Scenario	Utility Level	
	Sam	Noah
<b>A</b>	50	40
<b>B</b>	30	40
<b>C</b>	40	45

- a. A
- b. B
- c. C
- d. A and C
- e. B and C

8. The idea that a perfectly competitive free market economy will be Pareto efficient is known as

- a. General equilibrium theory
- b. Macroeconomic equilibrium theory
- c. The first fundamental theorem of welfare economics
- d. The perfect information theorem
- e. The second-best theorem

9. In the traditional model, under conditions of perfect competition,

- a. Goods will be sold at precisely their marginal cost of production.
- b. Wages will equal prices.
- c. Market power plays a role in determining resource allocation.

- d. Consumers will receive variable utility from the last unit of each good consumed.
  - e. All of the above are true.
10. Which of the following statements is *not* part of the intellectual foundation for the idea that “free market economics” is the best way for a society to maximize welfare?
- a. Independent, decentralized, voluntary decisions can give rise to spontaneous social order.
  - b. Markets lead people to make individual decisions that jointly result in an orderly and efficient allocation of resources.
  - c. In a general equilibrium model, prices and quantities are simultaneously determined in all markets.
  - d. Under perfect competition, consumers get exactly the same marginal utility from the last unit of each good consumed.
  - e. Under conditions of perfect competition, goods are sold at the point where marginal revenue is equal to marginal utility.
11. Which of the following ideas is *not* part of free market ideology?
- a. Market forces may fail to counteract the forces of racism and sexism.
  - b. Labor market discrimination is expected to disappear over time.
  - c. Protection for “infant industries” should not be necessary.
  - d. Economic actors are assumed to have no market power.
  - e. Both a and d are correct.
12. Modifications and extensions of the neoclassical model have been developed to account, at least partially, for
- a. externalities
  - b. public goods
  - c. imperfect information
  - d. the lack of markets for some goods and services
  - e. all of the above
13. Which of the following statements is *true*?
- a. The free market model is clearly accurate, but not necessarily precise.
  - b. The free market model is precise.
  - c. The free market model is considered to be accurate by virtually all social scientists.
  - d. Accuracy and precision do not always coexist.
  - e. Both b and d are true.

14. Institutional economics
- a. Was particularly influential in the Soviet Union.
  - b. Emphasizes the influence of habit on individual behavior.
  - c. Is also known as Marxist economics.
  - d. Was the basis for “Reaganomics” in the 1980s.
  - e. Both a and c are true.
15. The regulatory and social welfare policies of the Progressive Era and the New Deal in the United States were strongly influenced by
- a. institutional economics
  - b. marginal thinking
  - c. Marxist economics
  - d. post-Keynesian economics
  - e. feminist economics
16. Contextual economics draws upon
- a. Ecological economics primarily.
  - b. Ecological and feminist economics only.
  - c. Neoclassical economics only.
  - d. Many economic schools but not neoclassical economics.
  - e. Many economic schools, including neoclassical economics.
17. Which school of economics would be most likely to be associated with the following statement? “The study of caring labor (e.g. caring for the elderly) deserves a more central place in economic analysis.”
- a. ecological economics
  - b. feminist economics
  - c. Austrian economics
  - d. post-Keynesian economics
  - e. neoclassical economics
18. Which school of economics would be most likely to be associated with the following statement? “The entrepreneur plays a particularly important role in the economy, and thus should be a major focus of economic analysis.”
- a. ecological economics
  - b. feminist economics
  - c. Austrian economics
  - d. post-Keynesian economics
  - e. neoclassical economics

19. Which of the following statements is *true*?
- a. Market mechanisms are designed to ensure intergenerational equity.
  - b. A single person may have different preferences depending on whether he or she is thinking as a consumer or as a citizen.
  - c. Markets exist for all goods that people value.
  - d. The individualist ethic justifies all voluntary actions, including selling other people into slavery.
  - e. All of the above.
20. Neoclassical and Austrian economics are associated with
- a. the individualist ethic
  - b. ecological economic outcomes
  - c. intergenerational equity
  - d. the recognition that consumers are also workers and citizens
  - e. all of the above

### **Answers to Active Review Questions**

- 1. neoclassical
- 2. Pareto
- 3. perfectly competitive; Pareto
- 4. general equilibrium
- 5. institutionalist
- 6. individualist
- 7. Marxist
- 8. second-best
- 9. normative
- 10. intergenerational
- 11. True
- 12. True
- 13. False
- 14. False
- 15. False
- 16. True
- 17. False
- 18. False
- 19. False
- 20. The neoliberal position holds that societies should be organized with almost exclusive reliance on markets and private ownership.
- 21. Future generations have no way to make their preferences known in the market. Therefore, market outcomes are likely to favor the interests of people alive today over the interests of future generations. Thus, the balance between present and future generations is likely to be inequitable, with future generations getting the worse end of the deal, when decision making occurs primarily through markets.

22. Precision refers to information that is exact, although it may or may not be correct. Accuracy refers to information that is correct, although it may not be precise. For example, suppose two people, Robert and John, are estimating the cost of a meal at a local restaurant. Robert guesses that dinner will cost \$9.26. John guesses that dinner will cost “between \$15 and \$20.” Suppose the true cost of a meal at the restaurant is \$16.95. Robert’s guess was more precise, but John’s guess was more accurate. Similarly, the free market general equilibrium model may yield predictions that are very exact, but may have little relation to real world economies.
23. Institutional economics emphasizes the complex and changing nature of economic and social organizations and the importance of habit in guiding human behavior. Institutional economics often focuses on the ways in which social policy can help to solve problems such as poverty and unemployment.

### Answers to Problems

1. a. Yes, this change would satisfy the Pareto efficiency standard because both people’s utility levels would rise as a result.
- b. No, this change would not satisfy the Pareto efficiency standard because although Antoine’s utility would rise dramatically, Joe’s utility would fall slightly.
- c. One possible reason for Joe to agree to the change could be altruism: he might care about Antoine and want him to enjoy a higher utility level even if it involves some sacrifice on his part. He might also prefer to live in an economy that is relatively egalitarian, and thus might be willing to give up some of his own utility in order to help bring another person’s utility level closer to his own.

### Answers to Self Test Questions

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| 1. d  | 11. a |
| 2. c  | 12. e |
| 3. c  | 13. e |
| 4. a  | 14. b |
| 5. b  | 15. a |
| 6. d  | 16. e |
| 7. b  | 17. b |
| 8. c  | 18. c |
| 9. a  | 19. b |
| 10. e | 20. a |