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# **THEORETICAL FRAMEWORK OF PUBLIC POLICIES FOR WELFARE MAXIMIZATION**

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## **ABSTRACT**

The welfare state concept, which is related to welfare economics, has taken place in economics literature once again in recent years. The theories and theoretical supports are various. In this study, at first the concept of welfare economics was applied and then addition of Smith were added in the historical period.

On the other hand , the welfare economics which is based on Pareto, Pigou and Hicks-Kaldor's theories and also The social welfare function theory were examined.

At the end of the last part of study, the reasons of the government's interference on economics is appraised around the framework of the pareto optimal deviations.

**Keywords: Welfare State, Approaches, Government and Economy.**

**JEL Classification: H800**

## **1.Introduction**

One of the aims of the economics is to define how to augment the welfare of both the individual and the community with the help of the developments in 'economic theory' which analyses the economic events and 'economic policies which search for the right manipulations of welfare economics. Welfare economics tries to phrase how the individuals'and the societies welfare will be augmented both in theory and in feasible economic policy preventions.

As well as the improvements in philosophy in theoretical issues and the introduction of computers led the expansion of economies in a more rapid pace after the World War. Most of the economists have come to effective positions in public sector and they have played an important role in constituting public policies.

By means of, economics of welfare and economic policy, economic knowledge not only analyses economic issues but also has shown how to improve economic activities and how to get the desired consequences.

The purpose of welfare economics is to maximize the welfare of the individual and the community, and in order to achieve this, it has to research the needed precautions.Through the early thinkers of economies till current economists, they all looked for one thing; to find the best mechanism or system which leads to the maximum satisfaction point of the person and the community.

This paper study points out certain theories of the welfare economics and, in the light of these theories, we try to examine the fiscal policy precautions which are applied in Turkey after the 1980's .

## **2.The Framework Welfare Economics**

Economics of welfare lies within the normative economy. As it is known, science is divided into two categories, namely normative and positive. Positive sciences look for the answer of 'What' where as the normative sciences look for the answer of what "ought to be". Economics of welfare theory is closely related to economic policy. In order to explain the consequences of an economic policy, whether it is feasible or not, etc, we need the help of welfare economics.

However, it is the the aim of welfare economics to test the effectiveness of economic institutions.

Economics of welfare, when the effects of economic policies on the community's comfort is researched, can be a potential answer to such questions, 'what is welfare? How will the community's welfare be decided ?

The welfare means easy circumstances and happiness. Most of the time, social welfare and economic welfare mean the same thing in literature, Although, there is a difference in the theoretical aspect. Welfare is a subjective term and the situation of an individual who depends on many factors. These factors could be classified into two groups such as the ones which are economical and non-economical factors. Hence, welfare can be expressed explicitly as social welfare and economical welfare. Social welfare covers all factors which affect the individuals whereas the economic welfare deals only with the factors that are related to money.

The economic welfare of the individual is measured by the benefits he/she receives gets from the products and services. To measure benefit, both mathematical and economical theories, (respectively, ordinal and cardinal theories) are applied using various curves. Several discussions are held about the economic welfare of the community. The first subject, is that of how to predict the economic welfare of the community. A strongly supported thesis in this discussion is that the welfare of the community is implied by the welfare of the individuals who create that community. The second discussion is that of how to detect the increase or the decrease of the community's welfare. It is not possible to make a common generalization as we have done in the past, that is all of the individuals distinctive characteristics may not apply to the whole of the community. However, what we think about the individuals' welfare is not always the situation they are in. For example, a rich person may be counted as an individual in welfare to us, but he or she may not be happy with the conditions he/she are in and this will show us a failure in the results.

Stating these basic themes we can now discuss the three principals of Adam Smith's 'The Wealth of Nations(1776)', which is considered as the first monument of modern economy. The first one of these is the basic human motive of personal benefit, the second is the associate

benefit, and the third is to improve the national welfare whereby the governments' interferences should be minimized.

According to Smith, if every individual tries to get his/her benefit, they will then indirectly serve their community. Forwarding this hypothesis, Smith assumes that the market works out perfectly. This means if a product or service existed, consumers would have to pay a predetermined price per producers. Then entrepreneurs will always look for these opportunities. If the production cost is less than the selling price, then there is a profit and the producer will continue to produce this product or service soon. And another competitive firm will do the same job at a lower price. By this way better production techniques and better products for consumers are established. As a result, efficiency in production would be reached, moreover consumers would increase their gain. Hence, welfare of society could increase. The important point here is that there is no need for government's permission to produce. However, it is seen that the market does not always follow the path that Smith foresaw. Hence the crisis in 1930, the recession in the economy and the mass of unemployment could be given as an example of market failure.

After explaining Smith's approach, we shall discuss the ideas of Arthur Cecil Pigou about this subject to explain the fundamental theorems of welfare economy. Pigou is thought to be the founder of welfare economics. Pigou's utilitarian moral theories and its principals and the basis of the welfare economy. The old welfare economy and the utilitarian economy rely on two basic conditions. The first one is that every attempt to raise the per capita, Gross National Income and sustain fair income distribution and generally increase welfare. The second one is that without lowering the Gross National Income, every attempt is made to increase the income of the poor people in the community which will, increase the economic wealth.

Pigou made the following assumptions, to measure the wealth of a community:

- a. The benefits that an individual earns from his/her leisure time, income and wealth could be measured cardinally.
- b. The same units are used in measuring different individuals' benefits.
- c. All individuals have similar tastes.
- d. The overall benefit of a community is the addition of all individuals' benefits.

Pigou's assumptions were objected by to a British economist Robbins. Considering a third assumption Robbins, stated that the tastes of a poor and a wealthy individual would definitely differ and so they cannot be measured cardinally. Robbins objections could be given in two lines:

1. Economists should not be a side in solving the problems of community.
2. Appraisals could not be used in economic policy.

Since the 1950's the improvements in public finance and in public economics has been realized within the welfare economy framework. Thus, the analysis of the economics of welfare, could be done in two ways:

1. The reasons of public activities make up the first part of this analysis. This reason is named to be the market hitch.?
2. The second part of the analysis is about the government's interference.

In order to fully analyse the subject, both the old and the new welfare school approaches should be studied. The new schools members are Buchanan, Davis and Whisnston. According to the new school members the first aim of the public production is the concept of activity. The distribution of income is handled in the second place. On the other hand, the representatives of the old school, predicts the opposite.

The powers of competition is studied at that period by the theoretical approaches. Conclusion, the basic theorems of the economics of welfare, is categorized into two groups. The first basic theorem is that the economics of welfare uses some special sources in special conditions. In order to improve one's welfare, other's welfare may not be deteriorated by sharing the sources in the right way and this theorem is stated by Italian economist Wilfredo Pareto, giving the name pareto- effective, pareto-optimal distribution.

The first theorem of the economics of welfare is that as long as its benefit(social utility) possibilities let it, it will reach a certain point. On the other hand, the second theorem states that as long as the right source is used the competitive economy can reach to any point on the benefit possibility curve (social utility). It is important here to trust the markets economy mechanisms.

These theories discussed here are related to public policy making, basically there exists four theories of welfare which are, 1)Pareto optimality approach, 2)Pigou approach, 3)Kaldor and Hicks approach and, 4) The social welfare approach.

### **1.1 Optimalite Theory of Pareto**

The first person to discuss how to measure a communities welfare is Pareto and he had pointed out two important factors which are, income distribution and two, production order (pattern). He was not able to study the income distribution since there was no precise information about this and so he had focused on the effects of production order on the community's welfare..

According to Pareto, if an event happens to increase even one person's welfare without lowering the others', then it means that the overall welfare is increasing. And the optimum point at which the welfare is sustained is where there is this opportunity to raise even one person's welfare. However, to maximize the communities welfare two things are important; the existence of full competitive conditions and the pricing mechanism. If these two having been mentioned above do not exist, then a different approach is applied.

## **1.2 The Equal Satisfaction Capacity Theory of Pigou**

Pigou had mentioned the welfare that was measured by money. Pigou solved the problem of welfare maximization, not by management techniques as Pareto did, but rather by income distribution. According to Pigou's observation, a certain product would have the same effect and benefit for all individuals. Hence, he stated the theorem 'Equal Satisfaction Capacity'. On the other hand, he assumed that as the bulk of the product increased, the satisfaction level decreased. According to Pigou in order to maximize overall welfare, income should be absolutely equally distributed. However, he had objected in the sense that equal income distribution would prevent capital stock and decrease the total production. Another criticism was raised by positivists saying that equal satisfaction capacity was subjective and it did not rely on any certain science.

## **1.3 Hicks-Kaldor's Compensation Principal Theory**

New economics of welfare depends on the compensation principal. This theory discusses welfare theory from the income distribution point of view. It is impossible to measure the social welfare in this case, but there are three circumstances which need to be considered. These occur when the productivity and hence, income increases in the economy.

- a. All individuals incomes may rise.
- b. Some individuals income may rise whereas others income may not change.
- c. Some individuals income may have risen whereas others' income may have decreased.

In the first two of these circumstances, it is obvious that the social welfare has increased, but it is the third one which needs to be considered and, at this point Hicks-Kaldor's principal comes along. When the individuals whose income have risen compensate the others' income loss and if they are still in better condition after this exchange, then it can be said that overall income has risen. However, Hicks-Kaldor's principle and equal marginal benefit of money for everyone implied by Hicks-Kaldor's principle is criticised and does not relate income distribution to production.

## **1.4 Social Welfare Function Theory**

As its criteria is understood from discussions, economics of welfare should also depend on several evaluation criterians. This may be seen as a slight from positive economics to the normative economy, until analytical techniques are improved, "social welfare function theory" is an example for this situation. According to this theory, every economical factor which has an effect on a community's welfare can be expressed as a function. Social welfare function has complemented the logic and the mathematical side of the economics of welfare in theory, but indeed it does not have any dominance over practice. Because such a function is not feasible to any applied taxes. Though it seems that democracy is the best way to practice this function, it

contains some paradoxes in itself such as the public's irrational decisions originating from elections.

### **3.The Reason for Government's Interference in an Economy: Deviations from Pareto's Optimum**

The basic theorem of welfare economics states that economy is Pareto effective only in some certain circumstances. There are situations which are not Pareto effective and because these situations are events that are not eliminated within the market, they cause some interruptions. Hence, it becomes a reason for government to interfere. The aim of any government is to maximize public welfare. Policy makers previously mentioned the explanation of etc. related to economics of welfare management and share of benefit. Neoclassics asserted that the management and share of the benefit can be measured whereas Pareto had denied this claim. Using these ideas we will now study the optimum welfare conditions.

Pareto optimality indicates existence of some conditions, If a community has sustained the maximum welfare, a change in job, production techniques, source distribution should not be able to increase its welfare. Therefore, optimum welfare conditions should be examined with related topics of interference, production, investments and savings. In summary, there exist three types of conditions of Pareto optimum, these are;

#### **i.Interference Conditions**

- The marginal rate to substitution between any two goods should be equal for everyone.
- The marginal rate to substitution between any good and a leisure should be equal for the consumers and the producers.
- The marginal rate to substitution limit between any two jobs should be equal for all individuals who deal with that job.

#### **ii.Production Conditions**

- The marginal rate of transformation between two production factors should be equal.
- The marginal transformation limit between the two goods should be equal to the marginal substitution limit.

#### **iii.Saving and Investment Conditions**

- The marginal substitution limit between any share certificate and money should be equal to everyone who owns these items.
- The marginal substitution rate between any product and money should be equal to everyone who owns these items.

These conditions summarized above, are the conditions required for optimum welfare. Sufficiency of these conditions depend on several assumptions. First of all there should only be

one peak point of social welfare function. Otherwise we may be discussing some sub-optimal points.

After mentioning these issues, let's go back to the reasons of deviations from Pareto optimum. Pareto optimum reflects the market balance where there are no governmental regulations of competitive market. The defeat of this market balance has the same causes which also prevents the fair distribution of the sources. Here we face two problems; which unfairness in distribution and inefficiency in allocation of resources. The reasons for inefficiency are as follows;

- Prevention of full competency
- Prevention of balance
- Lack of markets –lack of future and insurance markets-
- Presence of outside effects
- Social properties
- Public properties and existence of valuable properties

In the shadow of these issues, full competency may not be feasible. Especially when dealing with monopolies, firms may reduce the production. On the other hand, a firm that is dominant in the market may be divided into several small companies, but this may result in the rise of the costs. If government does not act in telecommunication services fewer companies control the market. In this case a government either takes the overall control (like in Turkey) or only play a regulatory role in markets as USA does.

The second issue, the prevention of balance occurs because of the market's lack of information and some other problems and this gives rise to inefficient use of sources. Then the ultimate result is an economic recession, and a high rate of unemployment and the defeat of market economy. Today governments face many problems on these issues.

Other than these the defeat of market economy can be exemplified by unexpected inflation rates, unbalanced disbursements, etc.

Lack of markets is another issue that requires the government interference which is also another deviation from Pareto optimum. Even if the market is fully competitive, it still does not mean that it is Pareto effective. Since there exists no future market or no conditions about the future market, governments take the responsibility to intervene. On the other hand, if there is absolute balance, but information is lacking, then monopoly activities could be seen and this is not a Pareto effective situation.

Outside effects may cause uneffective results even if there is a balance or equilibrium in the competitive market. As both sides of the economic asset, namely individuals and institutions, may not deal with the effects that do not concern them, there may exist positive-negative outside effects. Government may support the positive external effects such as education, health



services, etc, and may limit the negative external effects such as pollution of the air and water, etc. As a result, these will be separate deviations from Pareto optimum.

Social properties are another reason for government's interference. Market mechanism cannot supply these kind of properties. The main social services are military services, judicial, basic research and development activities. The most important feature of these services are that the consumer groups of these services do not compete with each other and do not hinder others consumption.

Merit goods also need the government interference. Government support the production and the consumption of "normal goods" services such as milk, books, arts, sports, and limits the bad goods and services such as cigarette and alcohol advertisements. Governments should merit goods allocate resources in production of goods and design taxes.

Unfairness in resource allocation also necessitates immediate government intervention. Competitive market forces may have reached the Pareto effective position, but the share evolved with market progress may seem unfair to equal opportunity rule. In this situation any government share re-allocate resources of production. And government organize activities, such as tax systems and social aid transfers to achieve fair distribution of resources.

#### **4.1. Function of Modern Welfare Government**

Other classical government duties such as security, military, judicial and some other responsibilities have evolved and some of these have forced the government to step aside in some cases, for example, privatization. Some people may assert that a government should play the largest role in an economy –socialist economy regime- whereas others limit the governmental interferences –capitalist economy regime-. However, competitive market powers are thought to be more effective compared to these. Hence, modern governments should compensate the disparity of duties which are not done by the competitive market powers, these duties are summarized in three principals:

1. Economic activities that leads to arrange social collectible Socially collectible goods and services for maximize social welfare
2. Agreements of the basic needs that are not supplied by market mechanisms.
3. Sustainment of formal and objective laws instead of arbitrary and forced choices.

When we classify the duties of the government in an order of requirement level, the first one is to avoid social poorness and to supply social aid to afford basic needs of families. The second one is to provide health and education. The third is to support families and public communities financially like providing houses to homeless people, food to needy ones and provide books to some schools.

Other than these, government should also control the employment conditions, income distribution, fairness of judgement, economical and social plannings and many other functions.

Arýn mentions that the government of a welfare in relation democratics state should provide the social needs, social judgement, and equal rights to everyone.

On the other side, Nath explains these governmental duties by adding freedom of speech. Freedom of speaking out the ideas, arranging meetings, providing fresh and clean air, reasonable environment, dealing with arts and sciences, issues should also be acquired by the government.

## **5. Relating the Fiscal Policies Applied in Turkey After the 1980's with the Economics Of Welfare**

The countries' -in which the full competitive market exist- governments only have two duties which are; achieving the distribution of sources in a competitive condition, and improving the icome distribution.

In the recent two decades, Turkey wants structural changes in the economic policies as a result of corporation of IMF. There were great structural changes in the policies those were applied in the 1980's. Leaving the 1970's understanding of improvement with import substitutions, a liberalized trade improvement had been accepted. The precautions taken to overcome the high rate of inflation, lack of liquidity, and the disparity in current transactions are: central public expenditure at an aproprate level, providing, export incentives, payment debts regularly, liberalization trade,, convertible domestic currency, raising the interest rates,etc. When the consistancy program is studied, it is seen that the issues are handled only in a monetry point of view which lacks the social finance. The precautions taken which are supposed to maximize the welfare of the community will serve to economize of welfare as long as they affect the economy in a foreseen path. During this period, in order to compete with foreign countries' markets, there is an obvious slide of source from workers and officers of the government to the export orientated industries. However, the sources given were not used in sectors as were previously foreseen and they were used in speculative fields. As a result of policies it follow that both fair distribution of income, and efficient source allocation were not achieved.

Basically when a public finance effect over the welfare is studied, income and expenses must be handled at first. A new tax may disrupt the balance of the economy. Furthermore it may lower the welfare of the community. If this tax at hand is used for public expenses, it will act as a factor which enhances the welfare. An individual needs may be classified into two groups. First one is the private needs and the second is the collective needs. Public finance is interested in the second issue. If the collected taxes are used for this purpose, then the welfare of both the individual and the community will rise.

Purchasing power from rich to poor people. Transferring income (purchasing power) from rich to poor people is another tool applied by governments to raise the welfare of nations.

After the 1980's, the government had frequently borrowed money from both foreign and domestic sources and agencies. The efficient use of borrowed money could have improved the welfare of the Turkish people.

On the other hand, high rates of inflation may reduce welfare whereas low rates of inflation may increase welfare.

If the Pareto optimal is not achieved, then the deviation from the foreseen situation will occur and the result will be a lower income and source distribution which we name this theory as 'the second best theory'.

Stabilization programs applied after 1980's are not sufficient to increase the welfare of the community.

## **7. Conclusion**

Welfare economics and the precautions taken for the maximization of the social welfare is a branch of economic theory.

In order to raise the welfare of the community, several tools such as fiscal policy, price policy, etc. could be used. The effects of economical policies on welfare change according to the tools used. These policies sustain an economic stability rather than increasing the welfare of society. It can be stated that fiscal policies are not enough to increase welfare.

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