The Efficiency Argument for Capitalism

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Justice and Well-Being

One argument for Free Market Capitalism appeals to its *efficiency:* it is a highly productive economic system, it leads to high overall levels of well-being.

EFFICIENCY ARGUMENT FOR CAPITALISM

P1 An economic system is just if it makes all who live under it better off than they would be otherwise.

P2 Free Market Capitalism makes all who live under it better off than they would be otherwise.

C Free Market Capitalism is just.

This is a valid argument. Is it sound?

The Fundamental Theorems of Welfare Economics

Support for **P2** of the argument comes by way of two theorems. The first says, roughly, that a competitive free market will in equilibrium achieve Pareto-efficiency. The second is, roughly, the converse: every Pareto-efficient distribution is achievable by a competitive free market.

Pareto-Efficiency: An outcome X is *Pareto-Efficient* if and only if there is no other feasible outcome Y such that (i) no one is worse off in Y than in X, and (ii) someone is better off in Y than in X.

In other words, a Pareto-efficient outcome is one in which no one can be made better off without making someone else worse off.

> Here's another way to describe Pareto-Efficiency:
>
> An outcome X is *Pareto-Efficient* just in case there is no other feasible outcome Y that Pareto-dominates X.
>
> And, an outcome X is *Pareto-dominated* by Y just in case (i) no one is worse off in Y than in X, and (ii) someone is better off in Y than in X.

First Fundamental Theorem of Welfare Economics: If x is a competitive equilibrium, then x is Pareto-efficient.

This theorem is basically a formal statement of Adam Smith's *Invisible Hand Hypothesis:* under a system of free exchange, people act as if "led by an invisible hand" to promote an outcome that is to the benefit of society overall. Suppose x is a Pareto-Efficient outcome. Does that make x a good, or desirable outcome?

> "He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . [H]e intends only his own gain, and he is in this, as in many other cases, **led by an invisible hand** to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it." [Smith, 4.2.9]

THE EFFICIENCY ARGUMENT FOR CAPITALISM 2

> **Second Fundamental Theorem of Welfare Economics:** For any
> Pareto-Efficient outcome x, there is some possible initial distribu-
> tion of resources such that a perfectly competitive market starting
> from that initial distribution will achieve x in equilibrium.

Being Pareto-Efficient is not *sufficient* for being a desirable outcome,
but it (plausibly) is a *necessary* condition. The best economic distribu-
tion, whatever it is, better be Pareto-Efficient. This theorem says that
such an outcome, given the right initial conditions, will result from
free unfettered exchange in a competitive Free Market.

Gibbard puts the lesson of the two
theorems this way:
  "The two Fundamental Theorems
of Welfare Economics, then, seem to
say this: *although not every distribution
resulting from free exchange will be morally
satisfactory, some distribution achievable
with free exchange will be.*" [Gibbard, pg.
26]

Do the Theorems Support P2 of the Efficiency Argument?

1. **Unrealistic Idealizations?** In order for the theorems to hold,
   certain assumptions must hold: (1) that everything that matters
   in life comes from the private consumption of goods; (2) that
   there's perfect information; (3) that commodities are infinitely
   divisible (and everyone's preferences are "locally nonsatiated");
   (4) everyone is perfectly economically rational.

2. **Omniscience?** In order to use the Free Market to achieve the
   best economic distribution, we need to know which initial dis-
   tribution of resources will result in that distribution. But there is
   no practical way of working this out.

Is Efficiency Enough for Justice?

So much for Premise **P2.** What about the first premise? Is it true that
*an economic system is just if it makes all who live under it better off than
they would be otherwise?*

Some Questions to Think About:

1. What is meant by "better off" here?

2. What is meant by "otherwise"? What is being compared to
   what?

3. Is an outcome in which everyone is better off than they would
   be otherwise, thereby, the best (or even a desirable) outcome? If
   it is good for everyone, does that make it good overall?

4. Is overall well-being all that matter with respect to justice?