

Title	次号目次 奥付
Sub Title	
Author	
Publisher	慶應義塾経済学会
Publication year	1972
Jtitle	三田学会雑誌 (Keio journal of economics). Vol.65, No.11 (1972. 11)
JaLC DOI	
Abstract	
Notes	
Genre	
URL	<a href="https://koara.lib.keio.ac.jp/xoonips/modules/xoonips/detail.php?koara_id=AN00234610-19721101-0077">https://koara.lib.keio.ac.jp/xoonips/modules/xoonips/detail.php?koara_id=AN00234610-19721101-0077</a>

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# Market Distortion and Economic Welfare (I)

by Kunio Kawamata

We consider a multi-commodity economic model with classical characteristics in which one group of agents is guided by different prices from those of the other group. This situation arises in various branches of economics, as exemplified by the case of sales taxes and subsidies and that of import and export tariffs in international trade.

We define a measure of market distortions as the difference of equilibrium marginal rates of substitution between the two groups, and ask whether a decrease in distortions implies an increase in economic welfare. To be more explicit, we examine, whether or not each of the equilibria with a smaller distortion is Pareto superior to each of the equilibria with a larger distortion. The answer turns out to be negative in general. But two sets of sufficient conditions, both due to Foster and Sonnenschein [1], are known to rule out such "exceptional" cases. One is the case when there are only two goods in the economy and both goods are superior, and the other is the case when there is no inferior goods and production takes place at a constant marginal rate of substitution.

We provide a rigorous proof for the first case which was only informally treated by Foster and Sonnenschein [1], and give an independent and more direct proof for the second case. But we observe that these conditions are too restrictive to guarantee our intuitive idea that a decrease in distortion implies an increase in welfare. In fact many counter-examples for our original question can be constructed even under a fairly normal preferences and production sets.

We may thus ask if corresponding to each equilibrium with non-zero distortion there exists a Pareto superior equilibrium with a smaller distortion. The answer turns out to be affirmative for a considerably wide class of economic environment. This basic theorem of market distortion and welfare will be stated and proved in Part II of this article, to appear in vol. 65, No. 2-3 of this journal.

## Reference

- [1] Foster, E., and H. Sonnenschein, "Price Distortion and Economic Welfare," *Econometrica*, Vol. 38 (March, 1970), 281-297.

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### 資 料

Trade and Development

—Cambridge Conference on Development, 1972—……………深海 博 明

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第65巻 第11号

昭和47年(1972)11月1日 発行

定価 200円 千 24 円

編 集 兼

慶應義塾経済学会

郵便番号 108

東京都港区三田2丁目15-45

発 行 人

代表者 千種 義 人

電 話 03-453-4511

振替口座番号 東京 44056

購 読 料

1ヵ年 2400円, 6ヵ月 1200円 (送料共)

発 売 所

慶 應 通 信

郵便番号 108

東京都港区三田2丁目19-30

(購読料を添えてお申込み下さい)

電 話 03-451-3584

振替口座番号 東京 155497

印刷・製本 図書印刷株式会社