Question (2)

Consider an exchange economy with 2 goods and 2 consumers . Consumer 1’s initial endowment is and consumer 2’s endowment is . In each case , the first entry in the endowment vector denotes the initial endowment of good 1, and the second entry the initial endowment of good 2 . Both consumers have the same consumption set: , and the same utility function: Suppose that consumer 1’s expenditure on good 1 is taxed at a rate of 50%, and that the revenue from this tax is paid as a lump-sum transfer to consumer 2.

Find the Walrasian equilibrium of this economy . Then find another allocation which Pareto-dominates the equilibrium allocation.