Merit Goods: Some Thoughts on the Unthinkable

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RATIONALITY, INDIVIDUALISM and PUBLIC POLICY

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The elements of the formal theory of value in contemporary economics are deceptively simple: a rational person can rank states of the world from bad to good. The real numbers can be ranked from small to large. Therefore, better states can be associated with larger numbers. By this association, the problem of making the best available choice is recast as the problem of finding the largest attainable number.

The mathematics of optimisation is purely formal because it concerns the satisfaction of preferences, whatever they happen to be. In contrast, a substantive theory of value must say something about the content of preferences, not just their form. In economics there are two intertwined traditions concerning substantive values. First, according to the utilitarian tradition, the value of something is the total pleasure that individuals obtain from it. The pleasures of individuals are added to yield the sum of utilities, whose maximisation is the utilitarian's goal. Second, according to the market tradition, the value of something is the total amount that individuals are willing to pay for it. The prices people are willing to pay for the goods they enjoy can be added to compute the wealth of the nation, whose maximisation is the market economist's goal.

Should value be measured by pleasure or price? The policy issue which divides the two schools of economics is income redistribution. Utilitarians assert that the value of wealth is the pleasure it affords to people. Material needs are felt so keenly that a poor person allegedly obtains more pleasure from an additional dollar spent on necessities than a rich person obtains from an additional dollar spent on luxuries. In contrast, market theorists assert that, since wealth is the final measure of value, economists can say nothing about its value. In particular, they can say nothing about the value of wealth to different classes of people.

Thus the two schools are joined in a lively debate that provokes sharp barbs and yields valuable insights from time to time. The joining of debate is facilitated by agreement upon common assumptions requiring no discussion. One common assumption is that value attaches exclusively to individuals, either in the form of pleasures they enjoy or prices they are willing to pay. Thus the value of an institution or organisation is merely the aggregation of the pleasures of affected individuals. Bentham (1973) expressed the argument succinctly: 'The interest of the community then is, what? — the sum of the interests of the several members who compose it.'

An alternative assumption is that some values cannot be reduced to pleasures or prices. The possibility of social values requires modification of the mathematical model at the core of the economic theory of value. The formal theory begins, as noted, with the idea that a decision-maker can rank states of the world from bad to good, and concludes with instructions for the satisfaction of his preferences. Social values require a social ranking that is not simply an aggregation of individual decision maker's rankings.

Social values remain outside the framework of economic theory because they resist mathematical formulation and they collide with established theories based on price or pleasure. Lying outside the framework of economic thought, social values are unthinkable within it. Instead of an economic theory of social goods, there is only a name — merit goods. Like an evaporation pond at the mouth of a mine, merit goods collects the residue that the economic theory of decision-making cannot assimilate. Unthinkable thoughts find a distorted expression in the life of the mind that must be unknotted to restore clarity. This comment on Walsh's paper offers some suggestions to economists for thinking the unthinkable.

1. Walsh's Formalisation

The first step is for economists to understand the change in analytical methods required by social goods. Walsh has made a useful proposal in this direction. The allocation of goods in the economy is represented by a vector \( X = (X_1, X_2, \ldots, X_m) \). The degree to which the preferences of the \( i \)-th individual are satisfied is indicated by the variable \( U_i \), which is a function of the allocation of goods: \( U_i = U_i(X) \). The preference satisfaction of all individuals \( 1, 2, \ldots, n \) in society is represented by utility functions denoted \( (U_1, U_2, \ldots, U_n) \). According to the conventional economic representation, a social ordering \( W \) is a function of the satisfaction of individual preferences: \( W = W(U_1, U_2, \ldots, U_n) \). \( W \) is strictly individualistic because it is exclusively a function of the satisfaction of individual preferences. According to the conventional conception, social decisions should maximise a measure of value \( W \) that is reducible to individual values.
To represent irreducible social values, the social welfare function \( W \) must be modified so that it does not depend exclusively upon the satisfaction of individual preferences. Walsh suggests that if some goods have merit (or demerit) that is independent of their capacity to satisfy individual preferences, these goods must enter the social welfare function directly. Denote these goods \( X_k \ldots X_m \). The social welfare function is rewritten in the form \( W = W(U^1, U^2, \ldots, U^n; X_k \ldots X_m) \). Thus the satisfaction of the actual preferences of individuals, represented by \( U^1, U^2, \ldots, U^n \), receives weight, but merit goods \( X_k \ldots X_m \) receive weight in their own right. The revised social welfare function \( W \) depends upon irreducible social values because it does not depend exclusively on individual values. By maximising revised \( W \), social decisions are guided by a weighted combination of individual and social values.

Walsh goes on to derive the conditions for an optimal allocation of goods. According to these conditions, private goods and ordinary public goods should be supplied until the price people are willing to pay for them equals their cost. In contrast, the supply of merit goods must be increased beyond this point in order to reflect their irreducible social value. At the optimum, the cost of merit goods equals the sum of their irreducible social value and the amount people are willing to pay for them.

To illustrate Walsh's mathematical formulation, consider an example from Mill (1951). Pleasures, in Mill's opinion, differ according to their quality. Thus poetry affords a higher quality of pleasure than pushpin (a mindless bar room game). Even if poetry yields the same quantity of pleasure to one person as pushpin yields to another, the former should receive more weight in the social calculus than the latter. For Mill, poetry is a merit good whose value exceeds some peoples' actual preferences for it. The implication, according to Walsh's formulation, is that resources should be allocated to producing poetry in excess of market demand.

Walsh's mathematics in effect defines merit goods as goods whose total value exceeds their value to individuals. They have social value. The presence of social value tilts the optimal allocation of resources in their favour, which may require a subsidy. The subsidy is a wedge between their cost and the amount people are willing to pay for them. The size of the wedge is determined by the extent of the good's social value.

A wedge between cost and willingness to pay is not unusual in conventional economics, but, as Walsh explains, social value is not the conventional cause of the wedge. Rather, the conventional cause is the consumer's ignorance about the good's qualities, or the presence of externalities like pollution. These sources of market failure offer no challenge to individual values. The optimal size of the wedge can be computed in such circumstances by the standard techniques of cost-benefit analysis. In contrast, merit goods raise a problem that is outside the conventional 'market failure' framework and the size of the appropriate wedge cannot be computed by cost-benefit techniques.

2. The Politics of Merit Goods

The production of poetry in most countries enjoys subsidies from a variety of public and private sources, especially through free education, whereas I know of no government program to subsidise pushpin. This public policy appears to implement the merit goods concept, but the appearance may be misleading, according to Walsh. He conducts a 'search for merit/demerit policies' and he is unsatisfied that he has found any.

The reason for his dissatisfaction concerns the political economy of merit goods. The basic argument goes like this: preference for a good provides motivation for the individual to see that it is produced. No one has motivation to see that a good is produced in excess of his preference for it. Social value is, by definition, value that is not reducible to individual preference. Therefore, social value has no motivational force. Since it lacks motivational force, social value will have no observable effect upon the allocation of resources. Thus, we may beat the political bushes in search of social value, but we will never see it. Continuing the argument, the total value of a merit good equals the sum of its value to individuals and its social value. But the social good aspect is unobservable. Therefore we cannot in practice distinguish merit goods from plain goods.

This argument, while appealing, is flawed. I want to explain why and thereby help Walsh in his search for merit policies. The exposition is developed through a consideration of liberties and responsibilities.

2.1 Liberties

Political liberty combines permission and protection: the individual is permitted to choose and the exercise of choice is protected from interference by others. To illustrate, freedom of contract permits a person to choose whether to make binding promises and prohibits others from interfering with contracts. Our political tradition is committed to the idea that liberty has social value, independent of the value that a particular person places upon it. In fact, so much is given to liberty in our political tradition that a leading political theorist suggests that there is no trade-off between basic liberty and wealth (or preference satisfaction); instead, basic liberty is allegedly lexically prior to wealth in the social ordering (Rawls, 1971).

Lexical priority is an extreme form of merit good in which individual values are utterly trumped by social value. The trump is achieved by
arranging political life in such a way that the operation of the economic calculus is entirely blocked where liberty is concerned. The economic calculus operates effectively through the market and through cost-benefit analysis. It also operates, although more feebly, through political bargaining and majority rule. Blocking the economic calculus involves imposing obstacles to the operation of these institutions.

The economic calculus is deliberately blocked where basic liberties are concerned, even though the blockade is not as perfect as lexical calculus is. First, some liberties, called inalienable rights, cannot be sold in the market. Thus no one can sell his right of political expression or rid himself of the freedom to change his religious affiliation, even though blocking the sale of such rights is inefficient from the standpoint of preference satisfaction. Second, many liberties cannot be taken by a legislative majority. Thus in America the legislature would have to amend the Constitution in order to limit someone's freedom of speech. This is inefficient where, say, the religious majority would pay more to shut the mouth of an outspoken atheist than he would pay to speak. Third, the allocation of individual rights is left largely to judicial determination. The Constitution is so vague that the substance of individual rights comes largely from court decisions in which the judiciary has wide discretion. Judges apparently do not decide cases involving the basic liberties on the basis of an economic calculus.

These three devices shield liberties from the economic calculus that otherwise operates in markets and government. A legal entitlement that is shielded from the economic calculus will be called 'entrenched.' One political strategy for protecting social values is entrenchment. (But why should merit goods get entrenched, rather than entrenching special privileges for politically favoured people? This question concerns constitutional processes that we cannot examine.)

2.2 Responsibilities

A pluralistic society harbours alternative philosophies that converge on some issues and diverge on others. In a democracy, the area of overlap includes, we hope, agreement that the basic liberties should be entrenched. There are also significant areas of disagreement in which competing philosophies diverge. Furthermore, it is a feature of some of these philosophies that disagreements should not be settled by the economic calculus.

To illustrate, consider the decision of whether to dam a river and flood its rapids. In 1936 American Congress passed the Flood Control Act which states that '...the federal Government should improve or participate in the improvement of navigable waters ... if the benefits to whomsoever they may accrue are in excess of the estimated costs.' The need to implement this Act stimulated the development of cost-benefit techniques (Dorfman, 1976). According to these techniques, the value of white water should be determined in principle by ascertaining how much people are willing to pay for it. Thus, if Joe Potatoes is unwilling to pay anything to preserve a free flowing stream, and most people are like Joe Potatoes, white water has little value. In recent years, however, an ecology movement has emerged whose members feel a keen responsibility for the preservation of nature. They have a fundamental quarrel with cost-benefit techniques. To the secretary of the Sierra Club, the fact that Joe Potatoes does not value white water is a deficiency of his, not a deficiency of rivers. The secretary of the Sierra Club thinks that Joe Potatoes has the wrong values. The right value for purposes of social choice does not equal the sum of the wrong values. So, to the secretary of the Sierra Club, the value of white water cannot be found by summing the prices that people like Joe Potatoes are willing to pay for it.

The values in dispute are not regarded as matters of personal preference, but of public responsibility. Joe Potatoes is irresponsible towards nature. He needs to change. If public officials persist in proposing new power dams, they must be beaten in the legislature and the courts. The correct decision process involves public debate, legislation, and adjudication. Decision-making cannot be reduced to a technical procedure for summing individual values because those values are in dispute. So argues the secretary of the Sierra Club.

People who feel responsibilities keenly are attracted to the political strategy of entrenchment. For example, the Sierra Club wants wilderness areas protected by present laws that future legislatures cannot undo. But entrenchment of responsibilities is infrequent relative to entrenchment of...
individual liberties. Perhaps this is because individual liberties are in the intersection where competing philosophies agree, whereas disagreement is sharper over responsibilities towards nature, the poor, children, culture, or religion. Although the parties cannot agree over policies, they may agree upon processes for deciding policies. To be specific, they may prefer a public debate and a contest of political strength, rather than relegating the decision to an economic calculus. If so, they agree that merit goods are at issue, not plain goods.

3. Conclusion
If a decision only affects individual values, the best decision will be made by conforming to the economic calculus; but if social values are affected, the economic calculus may fail to produce the best decision. So the search for merit goods policies should focus upon situations in which people want decisions made by procedures other than the economic calculus. Liberties and public responsibilities are examples. Liberties are politically entrenched to protect them from the economic calculus. Public responsibilities are debated and ultimately decided by a contest of political strength. Analyzing liberties and responsibilities as if they were preferences distorts our normative categories beyond recognition. Instead, we need to modify the economic analysis to take better account of merit goods.

PATERNALISM, WELFARE ECONOMICS AND WELFARE POLITICS
Richard M. Bird

As one of the last speakers at a conference which has already heard from a long list of paper-givers and discussants, most of whom are clearly more knowledgable in the field than I am, there is probably relatively little I can say at this point that will not be trite, repetitious, wrong, or some combination of all three. In these circumstances, it seems to me that it is likely to be more useful if I respond to the convener’s invitation to discussants to range widely on issues suggested by the paper rather than comment in detail on the paper itself. This strategy has the advantage from my point of view of permitting me to talk more about what I think I know than what I know I do not know; and, if all goes well, it may also have the advantage of providing a slightly different perspective on some of the important questions we have been discussing at this seminar.

Since my perspective has been formed largely by my experiences in designing and implementing — or, to be more accurate, attempting to implement — tax changes in a number of quite different countries around the world, it is perhaps natural that one launching point for my remarks will be Cliff Walsh’s brief references to taxation and merit wants. My major concern in the general area of this seminar, however, extends far beyond this question to the whole problem of the normative relevance of conventional welfare economics for policy advisers — especially in circumstances in which few or none of the political conditions assumed, explicitly or implicitly, in all of the formal papers may realistically be considered to exist. While I realise that in some respects questions along these lines may go well beyond the remit of the formal papers, I think it is important to raise them anyway. This issue is not a trivial one nor is it in any sense hypothetical: rather, it is critical in principle to all who work in the policy arena, and it is necessarily resolved in practice, one way or another, every day in every part of the world.

My comments fall broadly into three categories, although they are not neatly organised under these headings in the exposition following but rather intermingled. First, I have a few specific comments on Cliff Walsh’s paper. Secondly, I want to make a plea for a closer look at paternalism. And, finally, as already mentioned, I want to raise the