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Retrospective Choice and Merit Goods*

by

Kaushik Basu

Informally speaking, merit goods are goods which people should be coaxed to consume more than their market behaviour leads them to. That some goods should be treated as merit goods most of us agree, but fail to express why we do so, with any rigour. This has given the opportunity to many laissez-faire economists to argue that merit goods are inventions of “paternalistic governments” and have no place in a society where the consumer’s sovereignty matters. This paper develops the concept of “retrospective choice” and in that light shows how merit good considerations may be necessary even in the absence of “paternalistic governments”. In fact, it will be argued that even for the limited objective of *Pareto*-optimality, certain commodities (which need not have any externalities in consumption or production) may deserve merit good status. It will be further argued that the objective of increased merit good production comes under the objective of maximising aggregate consumption and is not related to any other objectives¹. This paper concludes with a short discussion of one of the five cases which *John Stuart Mill* considered to be exceptions to the maxim of no government interference.

Commodities which have beneficial external effects on people other than the actual consumer have, at times, been called merit goods. *Musgrave* (1959) placed education under this heading. But this has been criticised by, among others, *Pulsipher* (1972) who argued that commodities with such characteristics should fall under the category of social goods. And this immediately makes this vulnerable to the attack of the *Coase*-Theorem which says that the benefitting party would pay the consumer to consume more of the commodity which has beneficial external effects and hence, through the market, attain *Pareto*-optimality, thereby removing the necessity of government inter-

* I would like to thank *Gautam Sen* and *P. Trivedi* for helpful comments on an earlier draft. Responsibility for all errors is, of course, mine.

¹ Usually, increased merit good production is considered to be an objective, independent of the objective of maximising aggregate consumption. See *United Nations Industrial Development Organization: Guidelines for Project Evaluation. Project Formulation and Evaluation Series, No. 2* (New York: United Nations, 1972). pp. 33, and *St. A. Marglin: Public Investment Criteria* (London: Allen and Unwin, 1967), pp. 22.

vention. There are, of course, counter-arguments to this, which *Coase* (1960) himself recognized, but we shall not dwell on that. Instead, we deal with the case where, even in the absence of external effects, the market might fail. This could happen if the consumer's retrospective choice diverges from his actual choice.

If a child is given the choice of either going to school or not, then the choice he makes is his actual choice. When the child grows up, say after twenty years, we could ask him what he would choose if he could go back twenty years. The choice he makes of what he would do if he could ride back on a time-machine, we call his retrospective choice. What happens if his actual choice and his retrospective choice are different? A market, we know, reflects the actual choice of people. Hence, a policy of non-interference implies an underlying philosophy that a consumer's actual choice is the right one. But since both, actual and retrospective choices, are made by the consumer, there is no justification for adopting such a philosophy. In fact, if it could be shown *ex ante* that his retrospective choice gives him a higher utility than his actual choice, then the government certainly has the right to intervene and encourage the consumer to choose what he himself would retrospectively prefer.

To put it more formally, assume that at a particular point of time an individual faces a vector, C , of choices. (In the above example of education, this would be a two-element vector: C_1 being education and C_2 being no education.) The choice which an individual actually makes is C_1 and we call this his actual choice. The choice which he would make, if he thought retrospectively, some years later¹, is C_j , and this we call his "retrospective choice".

Is there any reason why i will not be equal to j ? There seem to be three main causes for a divergence between i and j :

1. Tastes might change with experience. This is what *John St. Mill* meant when he wrote: "The uncultivated cannot be competent judges of cultivation."² This comment of *Mill* has often been confused with 2. below. Though *Mill* used this as an example of a case where government intervention was justified, it seems dangerous to do so; because a change of taste means a change in the utility scale of the individual and introduces all the problems of interpersonal comparisons. Indeed, if this were the only cause of divergence between retrospective choice and actual choice, then it would be difficult to justify government intervention. However, there are other causes.

2. Experience might reveal to the consumer that what he had initially thought to be the effects of the choice he made were quite different in reality. In this case, there is no change in taste involved. This bears close resemblance to *Mill's* reason 2 for violating the maxim of no government interference. This will be discussed in greater detail later.

¹ This "some years later" should ideally be a point of time when the entire effect of the alternative selected is over. In practice, we have to be less rigorous and settle for a length of time over which the major effects of the chosen alternative are over.

² *John St. Mill: Principles of Political Economy*, ed. by *W. J. Ashley* (London: Longmans, Green, 1926), p. 953.

3. $i \neq j$ could be caused merely by the fact that people have a pure discount of time. This can be demonstrated with a small example. Assume a two-element vector C , where the benefit stream from choice C_1 is b^1 and b^2 (the superscripts stand for the time periods) and the benefit stream from C_2 is a^1 and a^2 , assuming that there are only two time periods. Let the individual have a pure time discount rate of $r\%$. We also assume that the individual discounts the past and the future symmetrically.

Then at period 1, C_1 is chosen instead of C_2 , if

$$b^1 + \frac{b^2}{1+r} > a^1 + \frac{a^2}{1+r}.$$

At period 2, C_1 is chosen instead of C_2 , if

$$\frac{b^1}{1+r} + b^2 > \frac{a^1}{1+r} + a^2.$$

There is no reason why both the above inequalities should hold, or both be violated. If r is zero, then of course either both the inequalities will hold or neither. With a non-zero r it is quite possible that the former inequality holds while the latter does not, or vice versa, which implies a divergence in retrospective and actual choice.

If the cause of divergence is 1, then the problem is quite complicated. A man with a changed taste is like a different man, making his new utility incomparable with the old one. This raises all the usual complications of interpersonal comparisons. For simplicity, throughout the remaining pages, it is assumed that cause 1 is absent.

When a person faces a new choice vector, retrospective choice could be expected to be different (waiving aside coincidences) from actual choice because of cause 2. It takes experience to know what you want. Is there any reason to expect that in spite of this initial difference, i will eventually become equal to j ? It seems reasonable to assume that for choices which (i) are faced repeatedly and (ii) have their effects without a long time lag, after initial differences, i becomes equal to j . This is so because for such choices it is possible to have trial and error processes. If a consumer, after purchasing food, realises that it was not a worthwhile purchase (i.e. his retrospective and actual choices diverge) he would not make the same mistake again. He would keep altering his purchase, till through trial and error his retrospective and actual choices converge. But for choices of which the effects come with a long lag, or for choices which are confronted only a few times in life (e.g. a two-element vector, consisting of committing suicide by potassium cyanide or by hanging) a process of trial and error is not possible, and therefore there is a great possibility that i remains different from j .

Once cause 3 is coupled with cause 2, and given that the choices in question are such that (i) and (ii) are satisfied, there is certainly a strong case for expecting a persistent divergence in retrospective and actual choices.

Now, for choice situations, where there is a persistent difference between the retrospective choice and the actual choice, if the planner gets to know, *ex ante*, the retrospective choice of the consumer and also knows that that would give the consumer higher utility than his actual choice, then clearly the planner has reasons to put an extra weight on the retrospective choice and coax the consumer to choose it. This retrospectively chosen path (we could think of it in terms of a good or a service) can now be defined as a “merit want”.

More formally, C_j (the retrospective choice) could be defined as a merit want, if

- (a) $C_j \neq C_i$ (the actual choice) persistently, and
- (b) the choice of C_j instead of C_i would have raised the utility gained by the consumer.

Of course, a problem remains of identifying a merit want, i.e. a good which satisfies both (a) and (b). But it is incorrect to doubt its existence. Unfortunately, some of the criticisms against merit goods have been regarding their existence. Economists, steeped in the neoclassical tradition, have occasionally argued that a perfectly competitive economy, where consumers express their desires through the market, always leads to Pareto-optimality, and therefore any kind of government intervention is unwarranted and merit goods are mere expressions of planners’ whims which are imposed on the people. Such an argument is clearly incorrect. To deny the existence of merit wants is to assert that (a) and (b) cannot happen together. There does not seem to be much ground for such an assertion.

Viewed in this way, it ceases to be necessary to consider increased merit good production as a separate objective while doing planning and cost-benefit analysis. As shown above, merit want considerations are necessary in order to maximise consumption as valued by consumers. Therefore, it should come under the objective of aggregate consumption. Hence, the controversy regarding the justification of having merit good objectives in planning need not arise¹.

An example should help to clear up any doubts which the reader might have. Education is a typical case where the actual choice consistently tends to diverge from the retrospective choice – the former being the choice of no-education and the latter being the choice of education². This fulfils (a), but what about condition (b)? Can we assert that the retrospective choice is the one that gives the consumer higher utility, i.e. being educated would give him higher utility than remaining illiterate? Though no definite answer is

¹ Though the analysis of merit goods in “Guidelines for Project Evaluation” is somewhat similar to the one presented here, it considers merit goods to be unrelated to the objective of aggregate consumption maximisation. This happens because the notions regarding merit goods are not clearly spelled out.

² This is, of course, an empirical fact and may be questioned. However, even if the opposite were true, the analysis remains unchanged, except that “no-education” would then have to be substituted for “education” and vice versa, in the rest of the analysis.

possible, it does seem that in case of divergence, there is a good case for believing that (b) is satisfied. If the cause of the divergence is cause 2 (see page 221), then of course there is good reason to believe that (b) is satisfied. You are always wiser after the event. If, however, the presence of a non-zero and *symmetric* discount rate causes the divergence (cause 3, page 3), then the analysis can be quite complex. But it seems to me that there is a good case for arguing that the human discount of time is not symmetric; in fact, discount of the past is zero. To see this it is necessary to understand why human beings discount the future. It is because *experiences* imminent are more important than *experiences* far-off, whatever be the reason. The crucial thing is the fact that one has to experience the future. The past being a bygone can be viewed dispassionately, since it need not be experienced. An individual deciding on what he would do if he could go back to the past is somewhat like a planner, evaluating different projects without having the fear or privilege of experiencing them, and hence having a zero pure discount rate. If it is agreed that the discount of the past is zero, then there is good reason for believing that (b) is satisfied. This is so because the retrospective evaluation of the past must then be a comparison of total utilities of different elements of the choice vector (i.e. without discounting). Hence, the alternative chosen retrospectively must be the one with the maximum utility, unlike the actual choice which selects the alternative with the maximum present value of utility.

Sub-optimality of savings also can be explained in the framework of this analysis.

John Stuart Mill's cause 2, of the five cases which he considers to be exceptions to the maxim of no government intervention, has close relation to our analysis. This cause 2 of breaking the maxim is "when an individual attempts to decide irrevocably now, what will be best for his interest at some future distant time. The presumption in favour of individual judgement is only legitimate where the judgement is grounded on actual, and especially on present personal experience; not where it is formed antecedently to experience, and not suffered to be reversed even after experience has condemned it."¹

The two essential points which *Mill* makes is that "the choice must be such that (A) it cannot be reversed, even (B) after experience has condemned it". We stated in page 222 that i need not converge to j if the choice is faced *rarely*. *Mill's* "irrevocable" choice implies a choice vector which is faced only *once*. This, therefore, is merely a slightly stronger requirement than what we asked for, since "once" is just an extreme of "rarely". Hence, (A) says that the cause for persistent divergence in i and j must be fulfilled. (B) is clearly our (b). Hence, requiring (A) and (B) to be satisfied in order to justify government intervention is, in terms of our analysis, requiring (a) and (b) to be satisfied.

¹ *John St. Mill*, op. cit., pp. 959–60.

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