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MERIT GOODS DETERMINED BY SOCIETY VALUE JUDGMENTS – POLITICAL IMPLICATIONS FOR PUBLIC PARTICIPATION

Support from an empirical analysis concerning environmental goods

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Merit goods determined by society value judgments – Political implications for public participation

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Table of Contents

1	INTRODUCTION	9
1.1	Subject matter and objective	9
1.2	Novel field of research	13
1.3	Dissertation outline	16
2	SOCIETY VALUES AND THE MERIT GOOD CONCEPT	19
2.1	Discussing actor models and behavioral views with respect to society value judgments ...	19
2.1.1	General definition of society value judgments	19
2.1.2	Integration of society value judgments in different actor models.....	22
2.1.2.1	Traditional <i>homo economicus</i> model	22
2.1.2.2	Becker's approach.....	27
2.1.2.3	Multiple preference levels.....	32
2.1.2.4	Sen's approach	35
2.1.2.5	Citizens' versus consumers' decisions.....	38
2.1.2.6	Political Economic Person according to Söderbaum	40
2.1.3	Discussion and concluding definition of society value judgments	44
2.2	Merit goods and their impact within economics	51
2.2.1	Development of the subject and the definition of merit goods	51
2.2.2	Justifying the merit good argument	53
2.2.3	Merit goods and the norm of consumer sovereignty.....	58
2.2.4	Distinguishing between merit goods and other concepts in economics.....	61
2.2.4.1	Misunderstandings about and reproaches against merit goods	61
2.2.4.2	Related definitions of governmental intervention.....	63
2.2.4.2.1	Public goods	63
2.2.4.2.2	External effects	69
2.2.4.2.3	Transaction costs.....	70
2.2.4.2.4	Lack of information, uncertainty and information asymmetry	71
2.2.4.2.5	Myopia	73
2.2.4.3	Comparing the rationale for governmental intervention.....	74
2.3	Summary and conclusion	76

3 OCCURRENCE AND IMPLICATIONS OF SOCIETY VALUE JUDGMENTS IN AN EMPIRICAL ANALYSIS	78
3.1 Analyzing preferences for ecological goods	78
3.1.1 Ecological goods as merit goods	78
3.1.2 Original research objective and survey background	81
3.1.3 Choice of stated-preference methods	86
3.1.4 Survey Design	91
3.2 Survey results and conclusions	96
3.2.1 Response	96
3.2.2 Stated preferences	99
3.2.3 Subjectively felt incompetence	104
3.2.4 Stating society values for ecological goods	109
3.3 Effects on politics	115
3.3.1 Effects on agricultural politics	115
3.3.2 Effects on environmental politics	118
3.4 Summary and discussion	119
4 IMPLICATIONS FOR POLITICAL PRACTICE: DESIGN OF PARTICIPATION.....	122
4.1 Reasons for dealing with society's participation.....	122
4.1.1 Consumer sovereignty and welfare-enhancing potential	122
4.1.2 Participation as legal postulation	126
4.2 Participation in the provision process of ecological goods.....	129
4.2.1 The "Regional Advisory Board" and its functions	130
4.2.2 Integrating the regional population	131
4.2.2.1 Objectives	131
4.2.2.2 Survey concerning preferred parameters of participation	133
4.2.2.3 Discussion-based approach of integrating the population	138
4.2.2.3.1 Objectives	138
4.2.2.3.2 Survey design	141
4.2.2.3.3 Survey results and conclusion	143
4.2.3 Deduction of possible impact for merit goods in general	147
4.3 Critical analysis of efficient participation concerning merit goods.....	148
4.3.1 Current political administration	148
4.3.2 Objectives of efficient participation when merit goods are regarded	151
4.3.3 Discussion of possible design features for participation	156
4.3.3.1 Discussing participation processes	156
4.3.3.2 Discussing participants and representatives	160
4.3.3.3 Discussing decentralization	162
4.3.3.4 Discussing decision delegation	166
4.3.4 Modelling decision delegation in the provision process of merit goods	169
4.4 Summary and recommendations.....	174
5 CONCLUSIONS AND FURTHER RESEARCH PERSPECTIVES.....	178

REFERENCES.....	I
REGISTER OF LEGAL FOUNDATIONS.....	XIV
APPENDIX.....	XVI

LIST OF TABLES

Table 1: Compatibility of the presented actor models with society value	47
Table 2: Causes of confusion with merit goods	74
Table 3: Selected CBD articles	80
Table 4: Regional provenance of the respondents	97
Table 5: Age distribution of the target population and the sample	97
Table 6: Highest completed level of schooling of the target population and the sample	98
Table 7: Results of the ranking exercise	100
Table 8: Results of the grouping exercise	102
Table 9: Results of the budget game	104
Table 10: Preferred decision-maker	109
Table 11: Reasons for choosing this particular group to decide on ecological goods	110
Table 12: Spending budget on political areas	111
Table 13: Spending budget on environmental areas	112
Table 14: Preferred mode of questioning	134
Table 15: Willingness to spend time on the inquiry	135
Table 16: Willingness to learn more about ecological goods	136
Table 17: Willingness to travel for participating in citizen discussions	137
Table 18: Preferred parameters for public participation	137
Table 19: Gender of discussion participants	144
Table 20: Level of education of discussion participants	144
Table 21: Occupation of discussion participants	145
Table 22: Monthly net household income of discussion participants	145
Table 23: Household size of discussion participants	146
Table 24: Justifying participants according to the three elements of democracy	162
Table 25: Distinguishing between central and local coordination	163

LIST OF FIGURES

Figure 1: Structure of the underlying thesis	12
Figure 2: Political Economic Person	41
Figure 3: Relation of society values and selected economic approaches	46
Figure 4: Merit good scheme	66
Figure 5: Demand, treating “biodiversity” as either a public or a merit good	67
Figure 6: Payment scheme for ecological goods	83
Figure 7: Subjectively felt incompetence	105
Figure 8: Possible participation problem in the case of society value judgments	106
Figure 9: Efficiency-enhancing potential of integrating citizens	124
Figure 10: Demand for a private good treated as a merit good	149
Figure 11: Two participational steps when merit goods are concerned	152
Figure 12: Participation processes	157
Figure 13: Pay-off matrix	171
Figure 14: Draft of the use of the merit good concept for political decision-making	181

LIST OF ABBREVIATIONS

art.: article

CAP: Common Agricultural Policy

CBD: Convention on Biological Diversity

cf. to : confer to

c.p.: ceteris paribus

cp. to: compare to

CV: contingent valuation

CVM: contingent valuation method

D: demand

D_I : aggregated demand

EAFRD: European Agricultural Fund for Rural Development

EC: European Council

EEG: Erneuerbare Energien Gesetz (German regulation on renewable energies)

e.g.: exempli gratia (= for instance)

EU: European Union

f.: and the following page

F_i : individual i 's circle of friends

ff.: and the following pages

i: individual

I: income

ibid.: ibidem

i.e.: id est (= that is)

max.: maximize

min.: minimize

NGO: Non-governmental organization

p.: page

PEP: Political Economic Person

P_i : Individual i 's preference function

pp.: pages

p_m : price of commodity m

Q: quantity

Q^* : optimal quantity (in the equilibrium)

Q_I : aggregated quantity of individuals

Q_{\max} : saturation level

S: supply

sec.: section

U_A : Utility function of an altruist

U_i : personal utility

UNCCD: United Nations Convention to Combat Desertification

vs.: versus

W_i : societal welfare function

WTA: willingness-to-accept

WTO: World Trade Organization

WTP: willingness-to-pay

WTP_0 : willingness-to-pay in the original setting

WTP^* : willingness-to-pay in the equilibrium

X_m : good or service m

Preface

It happened that this piece of work turned into something different than was originally planned. This development should be viewed as a natural course of science and research.

Starting point of this research was a case study of an agri-environmental program in which the task was to look for means of participation for the regional population. In order to justify the establishment of an institution partly consisting of non-elected citizen representatives, who are to represent the citizens' demand, it should be analyzed whether this form of paternalism could be justified using the merit good argument. Thus, the intention was to analyze citizens' preferences for ecological goods by means of stated preference methods in order to compare these preferences to the decision of the board. However, after viewing the pre-test results and reading about the merit good concept, thoughts about the motivation of the respondents to answer the way they did came up and how participation in this case should look like. The merit good concept started to explain a lot more in the context of policy-making. Those, who expect economic research in the traditional way, i.e. choosing a method, collecting data, applying econometrics in order to verify or falsify compiled hypotheses, will be challenged by the comprehension of the concept of merit goods and the development of useful suggestions on how to deal with these insights in the political practice instead.

1 INTRODUCTION

Everything of importance has been said before by somebody who did not discover it.

Alfred North Whitehead, English mathematician & philosopher (1861 - 1947)

1.1 SUBJECT MATTER AND OBJECTIVE

The concept of merit goods states that certain demand decisions related to society's best interest should be made on the governmental, rather than the individual, level. This paternalistic intervention, therefore, must be justified by the merit good argument. The merit good argument states that the particular good or service is of such vital importance for society that the provided amount most likely exceeds the aggregation of the citizens' 'individual preferences'.¹ This work demonstrates the relevance of the merit good concept and presents means to legitimize the merit good argument in actual politics through appropriately designed participation.

Hitherto, only a small group of economists has dealt with the concept of merit goods and it can still be considered as a largely unknown niche concept.

Richard Abel Musgrave introduced the concept of merit goods (or merit wants) to economic theory, with a focus on financial economics (cf. to *Musgrave, R. A.* (1956/57), p. 341). Because the definition of merit goods has not yet become clear-cut, a definition is used which condenses *Musgrave's* definitions (which changed over time) to the features of merit goods considered as the most important (cf. to *Ver Eecke, W.* (1998), p. 149, *Musgrave, R. A.* (1973), p. 90 and *Folkers, C.* (1974)).

MERIT GOODS

Merit goods are goods or services whose consumption or production is encouraged by the government on the basis of society value judgments.

Governmental intervention is part of the definition because an analysis of governmental intervention started the economic analysis about merit goods and it has been heavily criticized for the explanation of intervention offered (cf. to *Musgrave, R. A.* (1956/57) and *Mc Lure, C. E.* (1968)). *Musgrave's* particular aim was to explain certain governmental interventions such as income redistribution and merit wants

¹ 'Individual preferences' refer to the individuals' best interest as opposed to 'societal preferences' which are related to society's best interest.

which cannot be explained by corrections targeting at an aggregate of individual's best interest.² The first efforts to explain the discrepancy between targeting society's best interest by interfering in (contingently distorted) individuals' best interests did not achieve the end of creating comprehension, acceptance, and significance of the merit good concept.³ One reason could be that 'society value judgments' were not yet integrated into economic analyses (cf. to *Ver de Eecke, W.* (1998), p. 133).

SOCIETY VALUE JUDGMENTS

Society value judgment means that people prefer to judge according to society's best interest rather than in their personal interest. (The difference between society value judgments and altruism, which can be part of individual interest, will be elucidated in section 2.1.1).

The primary objective of this work is to define merit goods on the basis of society value judgments. Society value judgments have gained interest in economic theory lately and have been introduced in order to explain decision-making which cannot be based on the maximization of individual's best interest.

The merit good concept is needed in order to legitimize governmental intervention which aims at a higher provision level than this which can be justified by the aggregation of the individual best interests of the population. It will be argued that *Richard Abel Musgrave* realized early that this intervention is reasonable and, hence, explained it economically by the introduction of the merit good argument (cf. to *Musgrave, R. A.* (1959)). However, in his early times, he seemed not to have the "right" explanatory instrument to define merit goods clearly, which is indicated by the changing definitions he used (cf. to, for example, *Pulshipher A. G.* (1971/1972), p. 278f or *Andel, N.* (1969), p. 631-637).

In order to explain the additional focus on participation while dealing with the merit good concept, their relation concerning the political practice must be elaborated.

Head wrote that there is a legitimate policy role for the merit good concept in a democratic society (*Head, J. G.* (1988), p. 13). However, governmental intervention

² *Musgrave* uses the term „merit want“, for example, in the context of an analysis on subsidies (cf. to *Musgrave, R. A.* (1956/57), p. 341).

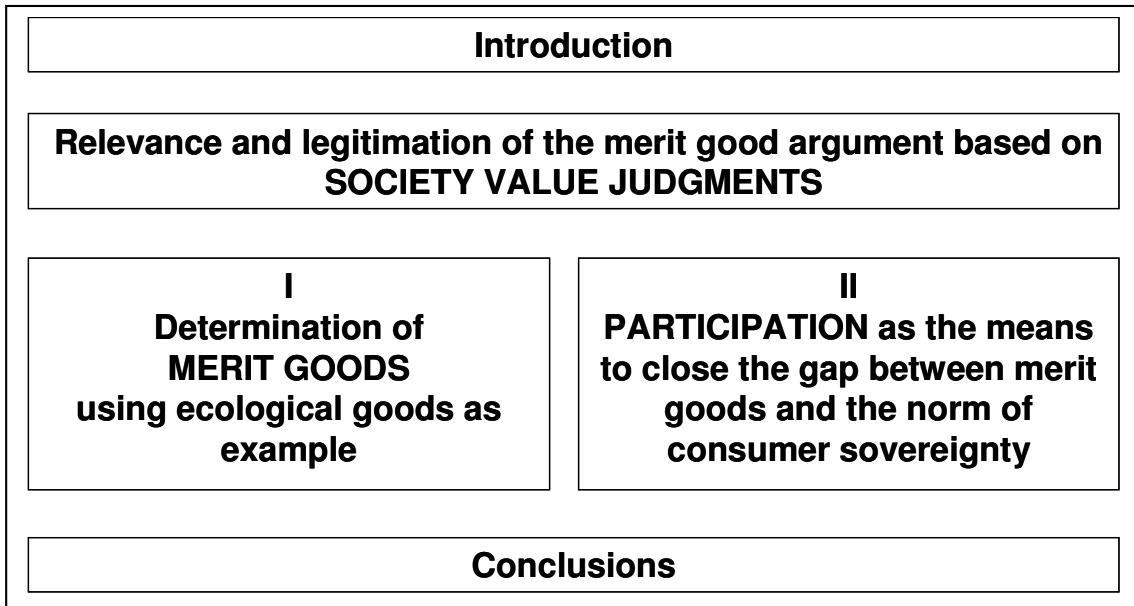
interfering with individual preferences is often considered as interfering with consumer sovereignty (cf. to *Musgrave, R. A.* (1998), p. 452 or *Mc Lure, C. E.* (1968), p. 479). *Musgrave* argued that the merit good concept has an authoritarian character which is not compatible with consumer sovereignty (cf. to *Musgrave, R. A.* (1959), p. 14). *Head* responded that *Musgrave* defines consumer sovereignty in too narrow a way and that the merit good concept, which supports public policy involvement, does not lie beyond the scope of consumer sovereignty (cf. to *Head, J. G.* (1988), p. 5, 8).

This thesis analyzes the concept of merit goods bearing in mind the norm of consumer sovereignty. It argues that both subject matters can be integrated by participation. Therefore, the merit good argument is considered as only justifiable if the citizens agree that the good or service under consideration is of such societal importance that society value judgments outweigh individual benefit judgments. Hence, the question of how to detect whether citizens do so must be answered.

Without the integration of the population, politicians may misuse the merit good argument for interest group steered interventions, such as subsidies for certain branches. That is why, in this thesis, a way of integrating these two approaches reasonably, through the development of recommendations for participation of citizens in the case of merit goods, is elaborated.

³ Nearly the entire analysis and discussion about the merit good concept has been traced in the journal “Finanzarchiv”. A summary of articles concerning merit goods can be found in *Head, J. G.* (1988), p. 3.

Figure 1: Structure of the underlying thesis



Source: own illustration.

Beyond the theoretical framework, presented in chapter two, this thesis comprises of two research areas relevant for the political practice. Chapter three offers guidance on how to determine a merit good by means of an example. In chapter four, recommendations for the political practice concerning the design of participation in the case of merit goods are presented. Moreover, it is argued that, while participation is heavily integrated into the German legal system, the merit good argument could gain relevance when it comes to legal actions. It will gain relevance in order to justify governmental interventions that are not based on the aggregation of individuals' best interests.⁴

Study background of the empirical and theoretical investigations on merit goods is the development of a political program to conserve agrobiodiversity. Further explanations and a more detailed description of the research project are given in the section 3.1.2. In the presented survey, initially conducted in order to analyze the regional population's individual preferences for specified ecological goods, stated-preference methods have been used. The choice of a ranking, a grouping and a budget game was made based on the fact that ordinal-scaled measures are sufficient for analyses in which budget and prices of the commodities to be demanded are exogenously determined for the citizens (in the case study through the budget and the

auction bids). The original foci of (a) an analysis of people's preferences for ecological goods, and (b) to design public participation, had to be broadened when it became obvious in the pre-test results that society value judgments are possibly involved.

One of the presumptions, here, is that the concept of merit goods is much more important in the area of environmental decision-making than economists have realized so far. However, in the environmental realm, the economic concept of merit goods is widely neglected or even unknown compared to the theory of public goods, for example. In this work, the motivation and reasoning to treat a good or service as a merit good, i.e. when to choose the concept of merit goods rather than one of the traditional approaches such as externalities, public or private goods, myopia etc., are pointed out.⁵ It will be argued that, while the political objective related to other economical explanations for governmental intervention is to guarantee a provision level according to the aggregation of individuals' best interest, the objective associated with merit goods is to provide the good or service according to society's best interest.⁶ If an empirical survey leads to behavioral results which cannot be explained, assuming that the people questioned are '*homines economici*', then the researcher has to analyze whether it is due to the ignorance of the subject or whether the research approach should be reconsidered because society values might be at hand and, thus, merit goods might play a role.

1.2 NOVEL FIELD OF RESEARCH

In order to put forward the novel approach used in this thesis, the only found empirical research on preferences for merit goods is briefly explained. Additionally,

⁴ Thus, especially in the environmental realm, the question no longer is whether integrating the people is reasonable or not in order to enhance welfare outcomes, but how to organize and design this integration.

⁵ In order to prevent misunderstandings it must be pointed out that the characterization as a public good is not questioned by the merit good approach. It will be illustrated in Figure 4, p. 66 that the classification of merit goods cannot be made within the context of public and private goods.

⁶ At first glance, there seems to be no difference. However, when, for example, a "saturated" person is willing to pay something in order to ensure that people without the necessary buying power will receive their daily nutrition level, the demand expressed through willingness-to-pay will be higher if society value judgments are involved. For detailed explanations, see chapter 2.

two suggestions on the subject are cited, which also point at a novel research issue in this field.

In order to empirically analyze preferences for merit goods *Johannes Schwarze* and *Gert Wagner* considered “compulsory old age security” as an example and recorded data of the satisfaction of people with existent old-age provisions (cf. to *Schwarze, J.; Wagner, G.* (1990), pp. 464-481). They conducted a multivariate data analysis, using satisfaction with the existent regime as the dependent variable and characteristics such as gender, employment, marriage, certain levels of household income, certain levels of education etc., as independent dummy variables (0=applies, 1=not applies). The aim was to make statements about the influence of socio-demographic characteristics on current satisfaction with the regime’s performance such as “people with particular characteristics are more or less likely to be satisfied with the existent regime”. However, *Schwarze* and *Wagner* did not specifically analyze preferences for merit goods, but preferences for the regime of how to deal with merit goods. This is interesting for the evaluation of regimes dealing with merit goods - and especially to determine what kind of people prefer what type of regime. However, this approach does not determine if a good is a merit good, or what the consequences should be for dealing with these goods. Rather than an *ex-post* analysis of the satisfaction with an existent regime as an indicator of preferences for merit goods, the underlying work analyzes preferences with an *ex-ante* perspective. By doing so, it can be determined if the paternalistic intervention itself is necessary and wanted: therefore, this thesis argues that in order to empirically analyze preferences for merit goods, first, the prevalence of society value judgments has to be tested and, second, preferences for the decision-making regime need to be determined.

Frank P. Maier-Rigaud holds that in order to decide whether a certain good can be turned into a merit good, it must be inquired on an individual level whether people’s interest is to choose the collective interest of society instead of their individual interest (cf. to *Maier-Rigaud, F. P.* (1998), see abstract and in sec. 4). Moreover, *Rigaud* finds that there is a lack of analysis of constitutional choices in literature (cf. to *Maier-Rigaud, F. P.* (1998), sec. 4). He says that “there are no *a priori* insights that would enable us to form a positive decision without normative inputs” from the public itself (*Maier-Rigaud, F. P.* (1998), sec. 4). Therefore, this work initially conducts an empirical analysis on whether the citizens’ intention is to choose

according to society's best interest instead of their individual interest, leading to the conclusion that ecological goods can be considered as merit goods. Furthermore, a way of allowing for meaningful participation by constitutional choices concerning the process of participation is analyzed, as *Maier-Rigaud* suggested.⁷

The findings in this thesis can be summarized as:

- 1) Due to the fact that the concept of merit goods is a niche concept and has not been elaborated in detail - the author of the concept, *Richard Abel Musgrave*, changed the definition of merit goods over time⁸ - this concept has been further established with a focus on society value judgments.
- 2) The relevance of society value judgments for economics has been elaborated by discussing their impact in selected actor models.
- 3) A testing procedure for the integration of society value judgments has been developed and indicators have been detected which hint at their prevalence in specific demand decisions.
- 4) A survey on preferences (individual and/or societal) for ecological goods and their provision was conducted.⁹
- 5) It is stressed, by means of an example, why stated-preference methods focusing on individual's best interest are not an appropriate approach if society value judgments are at hand.
- 6) Furthermore, this thesis points out the differences between the merit good argument and other explanations for governmental interventions. It was demonstrated that the pure aggregation of individuals' best interest is not a favorable approach to determine an appropriate provision level if society values are involved.

⁷ *Maier-Rigaud* states other examples which show that standard free trade theory can be challenged by constitutional choices, which are preferred over the possibility of individual choice (cf. to *Maier-Rigaud, F. P.* (1998), sec. 6).

⁸ An analysis of how Musgrave used the term merit good and changed his position over time can be found in *Andel, N.* (1984).

⁹ Using environmental goods (in this case: ecological goods defined for the larger research project) as an example of merit goods is uncommon. *Richard Abel Musgrave* (1998), however, mentioned it in the section on merit goods in the "New Palgrave".

- 7) Additionally, it was analyzed empirically whether and why the population legitimizes the governmental intervention – according to the principle of consumer sovereignty - through the delegation of the decision on the provision level.
- 8) Decision delegation viewed as a form of the widened principle of consumer sovereignty, as an indicator of the replacement of individual value judgments by society value judgments, provides new input into the long discussion about merit goods vs. consumer sovereignty.
- 9) Merit goods are defined as goods which are politically treated, i.e. political intervention in the form of promoting (or restraining from in the case of demerit goods) their consumption. Because of the growing participation requirements in political decision-making, the role of participation in the case of merit goods has been further analyzed.
- 10) Through discussing the relevance of different features of participation for merit goods, a reasonable way of dealing with them has been suggested.¹⁰

1.3 DISSERTATION OUTLINE

In the first chapter, questions and objectives of the underlying thesis are formulated. The background of the research and the importance and novelties of this contribution are highlighted. Furthermore, basic definitions are given, which will be readdressed in the description of the fundamentals in the second chapter.

In chapter two, the significance of society value judgments for merit goods is explained. Society value judgments are the explanatory pattern of merit goods which distinguishes the merit good argument from other rationales for governmental interventions. In chapter 2.1, the relevance of society value judgments for the explanation of individual's behavior is pointed out by discussing how society value judgments are integrable in different actor models, and the impact that society value judgments might had on the development of these actor models. Firstly, a general definition of society value judgments is given. Subsequently, after going through the behavioral approaches, the definition will be put in a formula. *Gary Becker*, for

¹⁰ When pointed out, the reasonable way of dealing with merit goods is adapted to ecological goods, i.e. to the proceeding in the larger research project.

example, realized a lack of explanatory power within the traditional *homo economicus* model (cf. to *Becker, G. S.* (1974)). Therefore, he worked with the integration of side conditions concerning the increase of social capital due to the cultural and traditional background of the decision-maker that influences the behavior still considered as purely rational and individual benefit maximizing (cf. to *Becker, G. S.* (1974) and to *Becker, G. S.* (1996)).

Other economists such as *Brennan* and *Lomasky* or *Amartya Sen* argued with different coexisting preference levels distinguishing between market preference, reflective (or altruistic) preferences and social preferences (cf. to *Brennan, G.*; *Lomasky, L.* (1983) and to *Sen, A. K.* (1982)).

Furthermore, the citizen-consumer concept has been developed (first by *Stephen Marglin*) focusing on different objectives people might have in the role of either a ‘consumer’ in the market place or as a ‘citizen’ concerning society-related questions (cf., for example, to *Marglin, S. A.* (1963)). This explanatory approach stems from the integration of the understanding of roles of sociology into economics. *Söderbaum* expanded the integration of knowledge from this field in his model of the “Political Economic Person” and segregates the decision-making context in different roles acting embedded in different contexts and in different networks or relationships (cf. to *Söderbaum, P.*, (1999)).

In chapter 2.2, the merit good concept is introduced starting with a definition and the justification of the merit good argument. Subsequently, the often discussed relation between consumer sovereignty and merit goods and other reproaches against the merit good concept are picked up. In order to highlight that the rationale and, what is even more important, the targeted provision level is most likely different compared to merit goods, the comparison of other reasons for governmental intervention is crucial to the discussion.

In chapter three, it is elaborated why ecological goods can be characterized as merit goods in this research project and its consequences for preference revelation and political decision-making. It is demonstrated how society value judgments influence traditional economic preference analysis. The empirical survey revealed that even though respondents were interested to decide and willing to participate voluntarily on a regular basis they admitted ‘subjectively felt incompetence’ which probably

occurred because they wanted to decide on the basis of society value judgments rather than according to their personal benefit. The statements the respondents gave in the pre-test interviews have underlined this rationale. The concept of merit goods, thus, could be considered as explaining the respondent's behavior in the given context. Beyond the problem with preference analysis when society values determine decision-making, the effects on politics, especially the impact on subsidy practice based on the merit good argument, are addressed.

In chapter four, the implications for the political practice are identified. It is highlighted that, in order to integrate the merit good argument and consumer sovereignty, participation is required to legitimize the governmental interference. Furthermore, it is analyzed how participation in the case of merit goods should be designed taking experiences of the research project into consideration. Within the context of the empirical study, in section 4.2, the participation of the population in the provision process of ecological goods is analyzed and discussed in order to derive general suggestions for participation in the case of merit goods. In section 4.3, however, more general thoughts on the political participation of society in the provision of merit goods are presented and evaluated.

In chapter five, the conclusions are drawn and the extent to which the results are transferable to other merit goods in the sphere of policy-making is highlighted. Furthermore, consequences that should be taken into consideration for the political decision-making are discussed. Finally, direction for future fields of research in this area are outlined.

2 SOCIETY VALUES AND THE MERIT GOOD CONCEPT

[T]he social order is a sacred right which serves as a foundation for all other rights.

This right, however, since it comes not by nature, must have been built upon convention. To discover what these conventions are is the matter of our inquiry.

Jean-Jacques Rousseau, philosopher, writer, political theorist (1712-1787)

2.1 DISCUSSING ACTOR MODELS AND BEHAVIORAL VIEWS WITH RESPECT TO SOCIETY VALUE JUDGMENTS

2.1.1 GENERAL DEFINITION OF SOCIETY VALUE JUDGMENTS

One aspect under which the, in economics traditionally assumed, actor model of the *homo economicus* is criticized is related to what various authors describe as the existence of ‘society value judgments’. Sometimes they are also referred to as ‘morals or ethics’, ‘commitment’ and ‘ideology’ or ‘political preferences’. It will be argued here that this ‘behavioral phenomenon’ has an influence on valuations, decision-making, and political decision support, which should not be neglected but incorporated into the analysis.

SOCIETY VALUE JUDGMENTS

Society value judgment means that people prefer to judge according to society's best interest rather than in their own personal interest. For example: a relatively wealthy student (having only wealthy friends) votes, nevertheless, in favor of a tuition fee level which depends crucially on the amount of money available for the student to ensure equality of educational opportunities for all students.

The term ‘society value judgment’ can be further clarified by relating it to the term ‘altruism’. Whereas for altruism it can be argued that the individuals addressed are related to the person, therefore limited, and affecting the person’s utility function, society value judgments address society as a whole (or even future generations). Thus, the difference between altruism and society value judgments can be seen in the group of individuals included in the preference function (P_i).

One can further argue that altruistic motivation is included in individual preferences, because a person gains personal well-being from the well-being of its friends or family. However, for society value judgment there is, as an extreme, even a decrease in personal benefit imaginable. As a consequence, the aggregation of individual

benefits when society value judgments are at hand cannot lead to the ‘societal demand’ when society value judgments are concerned – because these allow for a decrease in personal benefit. On the contrary, it can be argued that a societal welfare function (W_i) is a term of each person’s preference function (P_i) that expresses the person’s idea about what is good for society. The demand of goods or services considered in W_i is already an aggregate (which could be assumed to be concordant or similar for the relevant society, when merit goods are concerned).

A consumer i ’s individual preferences for different goods x_{i1} to x_{im} , which satisfy his or her needs better or worse, are usually represented by a personal utility function $U_i(x_i)$ in which x_i represents a bundle of goods x_{i1} to x_{im} consumed by individual i . The assumption that consumers maximize their total utility therefore corresponds to a maximization of U_i depending on the availability of a set of feasible goods and services x_{i1} to x_{im} . This is written as:

$$\text{Max! } U_i(x_{i1}, x_{i2}, \dots, x_{im})$$

subject to

$$p_1 * x_{i1} + p_2 * x_{i2} + \dots + p_m * x_{im} = I$$

where I is the income and p_m the price of the commodity x_m .

If the personal utility function $U_i(x_i)$ represents consumer i ’s preferences for a range of commodities and I the budget restriction, consumers – considering their budget – choose a bundle of goods x_g rather than a bundle of goods x_h , if $U_i(x_g) > U_i(x_h)$. In other words, the function U_i ranks bundles of commodities according to consumers’ preferences.¹¹

In order to point out the relevance of society value judgments in economic decision-making, a preference function P_i is needed, which not only includes personal well-being but is also capable of including the well-being of others. Since this is easily confused with the term ‘altruism’ it is of special importance to pay attention to the fact that there exists a variety of different definitions of ‘altruism’.

Sometimes altruism is defined as willingness to forgo a part of ones own welfare in favor of someone else (cf. to *Becker, G. S. (1982)*, p. 320). In this case, society value

¹¹ It can be shown that utility functions, systems of indifferent curves and preference systems following the standard assumptions (1) to (6) (see pp. 21f) are equivalent (cf. to *Schumann, J.; Meyer, U.; Ströbele, W. (1999)* p. 75).