Terra Economicus, 2022, 20(1): 38–51
DOI: 10.18522/2073-6606-2022-20-1-38-51

Public choice with regard to merit goods: A case study of private bank deposits

Andrei Vernikov
Institute of Economics RAS, Moscow, Russia, e-mail: vernikov@inecon.ru

Citation: Vernikov A. (2022). Public choice with regard to merit goods: A case study of private bank deposits. *Terra Economicus* **20**(1): 38–51. DOI: 10.18522/2073-6606-2022-20-1-38-51

This paper aims to extend Richard A. Musgrave's concept of merit goods by introducing the notion of a quasi-merit good. By that, the author means a private commodity that acquires merit unjustifiably via a manipulated political process preceding public choice. It is argued that within the original concept of merit goods, specifics are left to public choice in each society. Public choice can, however, be affected by special interests or a misconception, opening the way to public financing for goods of questionable public merit. To illustrate the author's theoretical claim, the paper brings up the case of private bank deposits. It is argued that bank stakeholders are the main beneficiaries of the uninterrupted supply of household savings. Exploiting the public desire for financial stability, bankers press for government intervention, mostly on paternalistic grounds, which are only partly justified. A government-backed deposit guarantee scheme nudges bank depositors to act in a manner beneficial for bank stakeholders, i.e., to keep supplying savings to banks. Private interests are pursued in the first place, which creates grounds for the claim that private bank deposits are a quasi-merit good rather than a genuine one. The proposed concept of quasi-merit goods complements the theories of public finance and public choice and potentially applies to other goods and services.

Acknowledgments: *My thanks go to the conference participants at the HSE-University (Moscow), Southern Federal University (Rostov-on-Don), WINIR Conference on Institutions for Inclusive Societies (Lund, 2019), Society for Advancement of Socio-Economics (2019), Institute of Economics RAS (Moscow), Alexander Rubinstein, Timothy Spence, two anonymous reviewers, and the editor of Terra.*

Keywords: *theory of public finance; merit goods; Musgrave; interest groups; public choice; welfare state*

JEL codes: *B52, D18, D70, E44, G21, G28, H42*

© А.В. Верников, 2022

Общественный выбор в отношении общественно-полезных товаров (на примере частных банковских вкладов)

Верников Андрей Владимирович
Институт экономики РАН, г. Москва, e-mail: vernikov@inecon.ru

Цитирование: Vernikov A. (2022). Public choice with regard to merit goods: A case study of private bank deposits. *Terra Economicus* **20**(1): 38–51. DOI: 10.18522/2073-6606-2022-20-1-38-51

Основываясь на разработанной Ричардом Масгрейвом концепции общественно-полезных или заслуживающих общественной поддержки товаров и услуг (в некоторых русских текстах – «мериторных благ»), автор вводит понятие псевдо-мериторных благ (quasi-merit goods). Под ними понимаются частные блага, потребление которых государство начинает стимулировать и финансировать без достаточных на то оснований, а из-за искажений политического процесса, ведущего к общественному выбору в пользу этих товаров. Утверждается, что исходная концепция «мериторных» благ оставила конкретный состав таких благ и прочие технические детали на усмотрение общества в каждой из стран. Однако на общественный выбор могут влиять группы особых интересов, равно как и недопонимание. Это открывает путь к финансированию общественными средствами товаров, значимость которых для общества в целом неочевидна. Теоретический посыл автора объясняется на конкретном материале – на примере института частных банковских вкладов. Автор считает, что главными бенефициарами бесперебойного притока частных сбережений в банковскую систему являются стейкхолдеры коммерческих банков. Они эксплуатируют такую общественную потребность, как желание иметь стабильную финансовую и расчётную систему, и добиваются государственного вмешательства в этой сфере, в основном под предлогом патерналистских мотивов, оправданных лишь частично. Создаваемая и финансируемая государством система гарантирования частных вкладов «подталкивает» (nudges) вкладчиков действовать определённым, желательным для кого-то образом: поставлять свои сбережения банкам. В первую очередь здесь удовлетворяются частные интересы, хотя они и выдаются за общественные. Это позволяет автору говорить о частных банковских вкладах как о псевдо-полезном с общественной точки зрения товаре. Впервые предложенное в статье понятие таких товаров и услуг претендует на то, чтобы дополнить теорию общественных финансов и теорию общественного выбора. Новое понятие потенциально может относиться и к другим товарам и услугам.

Ключевые слова: *теория государственных финансов; общественно-полезные товары; Масгрейв; группы интересов; общественный выбор; государство всеобщего благосостояния*

1. Introduction

The objective of this paper is to elaborate one of the aspects of the merit goods concept and the theory of public finance (Musgrave, 1957; 1959). The government resorts to paternalistic[1] intervention in order to promote the consumption of certain private goods and services, irrespective of the existing market demand for them, because such consumption serves long-term public interest (Musgrave, 1987). As substantial public funds can be involved in advancing such goals, it matters which

[1] Paternalism is interference of the government, motivated by a claim that citizens will be better off or protected from harm (Dworkin, 2019).

private goods are deemed to possess merit and which are not. The strength of the case varies, and the outcome depends on the specificities of collective action design and procedure in the given society. It is, therefore, easy to imagine a situation in which government support is sought for a private commodity that presumably satisfies a public want. But intervention would actually serve mainly private interests, or a viable private solution exists, or the scale of public sponsorship is exaggerated. I propose to designate such goods and services as pseudo merit goods or *quasi-merit goods*. The notion is compatible with the original concept of merit goods by Richard A. Musgrave and complements it as a special case.

The case of private bank deposits and government deposit guarantee[2] is intended to illustrate my thinking. Relations between a household and a private bank about the safekeeping of private savings seem to be as private as it possibly gets. That notwithstanding, I show how bank deposits attain, *de facto*, a status similar to humanitarian merit goods with regard to government protection and financing. The public want is to maintain financial stability, which translates into the stability of the overall aggregate of private bank deposits. One of the ways to satisfy this public want is to influence the individual choice and decision of the depositor by 'nudging' towards a desired behavior. The desired behavior is, in this instance, that depositors refrain from withdrawing funds from the bank, regardless of the circumstances. Private bank stakeholders join forces with the mass affluent to institutionalize government intervention in the depositary business, most commonly in the shape of a deposit guarantee scheme. The government is prepared to pay for that: the majority of such schemes worldwide are run by government or para-statal agencies, co-financed with public funds, and rely on national monetary authorities as a back-stop in the event of a shortage of funds. It is one of the avenues how bank losses get socialized, while profits are left in the private sector (Stiglitz, 2009: 288).

The commodity the supply of which is being influenced by a government guarantee is, therefore, a bank deposit. Public protection places bank deposits in the same league with commodities which are commonly granted merit by economically advanced nations. I argue, however, that private bank deposits are a quasi-merit good rather than a genuine one.

There is vast literature on public choice and its eventual aberrations, often concerning the tax regime. As for merit goods, the *FinanzArchiv* journal contains a cluster of relevant papers (e.g., Head, 1966; Brennan and Lomasky, 1983). I find few case studies of merit goods, such as the one on higher education (Arcelus and Levine, 1986), at least recently. This paper aims to fill the void.

The rest of the text is organized as follows. Section 2 summarizes the concepts of merit wants and merit goods. Section 3 describes the case of private banks deposits which attain a protected status similar to that enjoyed by commonly recognized merit goods. Section 4 deals with the arguments in favor of government intervention and the role of private interest, before introducing the notion of quasi-merit goods. Section 5 provides a conclusion.

2. Merit wants and merit goods

Musgrave refers to merit wants as "*those needs where government interference intends to increase the consumption connected with these needs*" (Ver Eecke, 2007: 19) and "*wants with regard to which consumer choice is abandoned*" (Musgrave, 1957: 341). Governments deem such an increase in consumption to be desirable due to the positive externalities, i.e., public benefits exceeding private ones. A short working definition for merit goods is: *"commodities that the public sector provides free or cheaply because the government wishes to encourage their consumption."*[3]

The merit good concept evolves from one of Musgrave's works to another. "*Musgrave vacillates between five different definitions (justifications) of the concept of merit good*" (Ver Eecke, 2007: 22). He notes that "*it seems difficult to assign a unique meaning to the term*" (Musgrave, 1987: 453). Education, free school lunches, basic healthcare and low-cost housing are common examples of merit goods. A merit good is usually produced privately, consumed privately and, without government intervention, provided privately, too.

[2] Hereinafter, I use the terms 'deposit guarantee', 'deposit insurance' and 'deposit protection' interchangeably.

[3] https://www.britannica.com/topic/merit-good

The ability of merit goods to satisfy a public want renders them similarity with public goods. However, merit goods do not qualify as public goods. "*Goods and services supplied in the satisfaction of public wants must be consumed in equal amount by all*" (Musgrave, 1957: 334). Unlike public goods, merit goods are more rivalrous, excludable, diminishable and rejectable. For instance, free school lunches are diminishable, excludable and rejectable. Access to national cultural treasures is limited by capacity. If one treats higher education as a merit good, then taxpayers act as 'suppliers' and students as 'beneficiaries' of the process (Arcelus and Levine, 1986). This case proves that a merit good is diminishable, excludable and rejectable, because higher education cannot be provided to all in view of capacity constraints and other considerations.

A merit good, "*by its very nature, involves interference with consumer preferences*" (Musgrave, 1959). One argument in favor of interference can be labelled 'anthropological' and is mainly about *ignorance*. Individuals may take an unwise decision because they lack information, resources, cognitive skills or willingness to appreciate the value that a commodity might hold for them. Another argument in favor of interference is that individuals are *myopic* (short-sighted) and maximize utility only in the short-run, disregarding the longer-term consequences of their decisions. A closely related argument is *irrationality* which supposedly drives human actions, leading to herd behavior, panic, etc. When individuals act irrationally, social interests are also affected'. Finally, there is the *unavailability* argument: citizens willing to protect themselves from risks find no adequate private solutions, and the government has to step in (Tanzi, 2011).

The notion of merit wants is controversial. Musgrave himself is ambiguous on it. On the one hand, he admits the need "*to take account of considerations broader than individual welfares in reaching social judgments*" (Atkinson, 1987: 392) and admits that "*individual preferences are affected significantly by social forces*". On the other hand, Musgrave rejects the notion that there are group wants, as such (Musgrave, 1957: 334).

The concept of merit goods establishes a theoretical ground for government paternalism and intervention connected with the use of public funds. In a totally free market economy, merit goods would remain under-consumed and under-produced. Government interference aims to 'correct' that. The reasons for meritorious intervention are consistent with the theoretical justification for the regulation of markets, namely market failure. "*In some cases, market failures may be ameliorated by nonmarket institutions*" (Stiglitz, 1989: 197). As far as merit goods are concerned, it is the general public dissatisfaction with the outcome of free market workings that pushes the government to support or discourage the consumption of commodities such as culture, schooling, healthy living, drugs, tobacco, gambling, etc.

For many scholars, it is taboo to assume that consumer preferences can be overruled and consumer sovereignty violated. Predictably, each theoretical reason for meritorious intervention has been challenged in the academic literature (Buchanan, 1960; Tietzel and Müller, 2002). An influential view in English-language tradition is that "*the state does not act as such, and it cannot seek its own ends or objectives*" (Brennan and Buchanan, 1985: 22). If a 'superior' choice does not emerge from political processes, then merit goods "*remain institutionally empty*" (Brennan and Lomasky, 1983: 184). Yet, other authors have no problem using such terms as 'social wants' (Baumol, 1993) or 'social needs' which are non-reducible to individual needs (Grinberg and Rubinstein, 2005: 33).

Theory is one thing, and policy practice just another. The welfare state is "*designed to correct the market-determined state of distribution, based on what society views as a fair or optimal pattern*" (Musgrave, 1996). All welfare states, without exception, encourage merit goods and discourage demerit goods. Sizeable shares of national budgets are spent on financing merit goods (Beckerman, 1986: 9). The specific set of merit goods and the prioritization of funding are influenced by cultural factors, producing a diversity of policies and arrangements across nations.

Meritorious intervention can take various shapes. Along with 'hard' (a.k.a. 'legal' or 'old') paternalism, which legally forces individuals to do or not to do something, there is 'soft' paternalism widely known as 'nudging' (Thaler, 1980; Thaler and Sunstein, 2003). Nudging shapes economic behavior of people without coercion by discouraging them from taking certain risks and making 'unwise' decisions. Nudging is a choice intervention and a delivery mechanism for merit goods.

Not just the 'hard' paternalism, but even the 'soft' variety of paternalism are attacked in the academic literature on the ground that policy-makers explicitly judge certain goals or ends to be worth advancing, regardless of how individuals evaluate them. Externally chosen interests may replace people's own interests (White, 2019).

Producers or consumers of merit goods are subsidized through public funds (Musgrave, 1959; 1987). Contingent liabilities that depend on the outcome of an uncertain event in the future are an alternative to direct government funding. Government guarantees are issued to intervene in activities which used to be fully run by the private sector, and deposit guarantee is the most prominent example. Thus, the state has evolved into a giant insurance company for its citizens (Tanzi, 2011). The low capital intensity of contingent liabilities for the government may be illusionary and, in the event that the sponsored activity fails, a contingent liability transforms into an explicit one.

Meritorious intervention has distributional effects. Musgrave writes ironically that some aspects of the public finance theory "*lead us into the thin air of welfare economics, where as yet the oxygen has been prone to give out before the peak was scaled*" (Musgrave, 1957: 333). The use of legislation to protect certain social groups from specific risks is tantamount to subsidization of such groups and taxation of certain sectors (Tanzi, 2011). Public expenditure produces the effect coined as Director's law: it is primarily the middle classes who benefit from public expenditure, whilst the expenditure is financed with taxes contributed in a considerable part by the poor and the rich (Stigler, 1970).

Apart from some general principles (see the previous Section), theory provides no uniform strict criteria to determine what is a merit good and what is not[4]. "*We shall call public needs those for which the State provides in any given country and at any given time*" (Barone, 1959: 165). In a similar vein, Musgrave calls merit goods those "*considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for through the market and paid for by private buyers*" (Musgrave, 1959: 13; Musgrave, 1996). It is, therefore, the government in pursuance of its social welfare function who formulates a judgment regarding the merit of this or another commodity. Following this logic, any goods and services are of merit in the event that the government provides them. Such a definition of meritorious goods appears to be circular and leaving no room for doubt in the wisdom of choice of the particular commodity.

3. Private bank deposits

3.1. Theory

The theory of government deposit insurance essentially offered an *ex-post* apology and intellectual legitimization to, rather than an *ex-ante* rationale for, an already existing and thriving institution. By the time deposit insurance was introduced in the USA (1933), economic theory had not made any clear pronouncements on the subject, and seminal papers came out only in the 1980s, i.e., a few decades later.

The original theoretical justification of deposit protection was expressed mainly in terms of bank liquidity and risk management. A depositor run – a massive one-time withdrawal of household deposits – can lead to bank failure, thus challenging systemic bank stability (Bryant, 1980; Diamond, Dybvig, 1983; Keely, 1990; Calomiris, 1999; Allen et al., 2015). A prudent and sound bank can also be affected by irrational or 'herd' behavior of its depositors. Negative externalities of bank failure go far beyond the affected bank. Financial instability is detrimental to society as a whole, so it is in the common interest that the system remains stable. That implies an uninterrupted flow of sufficient savings from the household sector. More specifically, the public want is to reduce the volatility of the aggregate volume of deposits. Intervention takes the shape of deposit protection (insurance, guarantee, etc.). A depositor now faces smaller potential losses or none at all when staying within the coverage limits, while the uninsured portion of the deposit remains at risk. Deposit guarantee does not coerce individuals, but affects their choice by 'nudging' (Thaler and Sunstein, 2003) them to act in a way desired by bankers, i.e., to refrain from withdrawing funds.

An essential condition for meritorious interference is *unawareness* or ignorance (Musgrave, 1987). Advocates of government deposit guarantee argue that depositors do not understand the risk

[4] Musgrave preferred abstract theoretical reasoning and was reluctant to cite empirical evidence (Prest, 1959: 768).

they take and that they lack information about the soundness of their bank. Deposit guarantee is supposed to deal with the *irrational* behavior of individuals such as panic, contagion effect, etc. Thus, intervention implies that a government knows what is rational and what is not. This approach deems an individual's preference to withdraw his or her own funds from a bank to be 'wrong' or 'distorted'.

I find it paradoxical that, while the very notion of meritorious intervention faces fierce intellectual opposition and rejection (see Section 2), the practical policy of delivering deposit insurance is seldom challenged. It now exists in 144 countries[5] and is still spreading around the globe. Only a minority of libertarian-minded economists advocate purely private schemes and government withdrawal (Hogan and Johnson, 2016). The economic mainstream, consisting of a broad range of schools and paradigms, silently accepts government-run protection schemes and focuses on minimizing moral hazard and other similar negative effects that deposit guarantee inevitably generates (Calomiris, 1999).

3.2. Political economy

Deposit guarantee was originally a political device. In the United States, the trauma of the Great Depression paved the way for an expansion of publicly-provided social insurance, including deposit insurance, unemployment compensation, public works, public ownership and similar institutional innovations (Rodrik, 2000: 8).

The adoption of deposit insurance results from internal and/or external political pressures[6] (Demirgüç-Kunt et al., 2008; Calomiris and Jaremski, 2018). Bank stakeholders perceive the public want of financial stability and join forces with savings holders to push for government intervention in the depositary business. To that end, the banking industry employs influential lobbyists in the government, parliament and other political institutions. Politicians as well as scholars often claim that 'there is no alternative' to a government-backed deposit guarantee, which is not quite accurate. There are many alternative ways to improve the soundness of the banking system. Deposit-taking had existed for centuries without such guarantee. Several alternatives to the Federal Deposit Insurance Corporation (FDIC) have been historically tried in the United States (Hogan and Johnson, 2016), mostly unsuccessfully, though. Many industrialized nations adopted deposit insurance as recently as in the 1980s or even later. The appropriateness of a government-run deposit guarantee scheme for developing or transition economies remains questionable (White, 1997), and even more so when the banking sector is populated mainly by state-owned or foreign-owned banking entities (Vernikov, 2019).

In the United States, the government neither demanded nor supported deposit insurance. While the House Banking Committee of the Congress was a strong advocate of state deposit insurance, it was opposed by the Senate Banking Committee (White, 1997). That was a reflection of the resistance of unit bank stakeholders, and the state bank regulators who patronized them, to the expansion of larger multibranch banks promoted by federal bank regulators. While the former were bidding for deposit insurance, the latter did not support it. Unit banks ultimately succeeded in defending their turf against competitors from outside their home state, thus delaying institutional change and, figuratively, turning the clock of banking regulation backwards[7]. My take is that FDIC and deposit insurance in the United States was a product – quite an accidental one – of politics and lobbying by a very narrow group of special interests, rather than a well-thought and well-intentioned strategic program, as some romantic economic scholars imagine.

In Russia, while the thrust of deposit protection is in line with the nation's historical tradition of paternalism and protectionism (Vernikov, 2020), the monetary authorities did not push for immediate enactment of deposit guarantee. The core market players including largest private banks, state- and foreign-owned banks did not lobby it either. The initiative was instead promoted by a

[5] https://www.iadi.org/en/deposit-insurance-systems/dis-worldwide/

[6] International obligations, such as those stemming from membership in the European Union, may require national authorities to install a nation-wide deposit protection scheme.

[7] "*The unit bankers' actions were largely defensive, but what they lacked in terms of leadership or a program they made up in brute political clout. This was not a result of their relative economic importance in the industry*" (White, 1982: 40).

small group of parliamentary members and experts with support from second- and third-tier market participants, foreign central bankers and governments and international organizations (Vernikov, 2019).

A populist narrative involving deposit protection is a good selling point for local politicians who appeal to a public sentiment damaged by the uncertainty and chaos of an economic depression, or a military conflict, or a transition from central planning.

Worldwide evidence suggests that government-backed deposit guarantee schemes are irreversible, with the exception of crisis-imposed provisional arrangements such as a blanket guarantee of all deposits. Politically, it is unfeasible to renounce or even publicly challenge existing schemes. Deposit protection is ever-expanding in terms of amounts covered and the scope. It is typical for state-financed programs to start small and continue to grow endlessly (Tanzi, 2011).

3.3. Effects

Within the framework of a welfare state, deposit insurance protects citizens against risks with economic consequences, which is – one of the roles of the government (Tanzi, 2011: 5). The effect of an abrupt loss of savings may be compared to the effect of income loss associated with illness, accident, job loss, invalidity, or death. The insurance of these risks, less deposit loss, has been in place in industrial countries since the 1880s.

It is commonplace that deposit guarantee affects the behavior of agents in the sense that depositors are less likely to panic and more likely to leave their funds with banks. Banking crises become less frequent and severe. As for bank stability, the effects are contradictory. On the one hand, banks acquire a safety net that helps prevent failure. On the other hand, when deposit guarantee is in place, banks adopt more risky business models and, thus, become more fragile (Keely, 1990; Allen et al., 2015; Chernykh and Cole, 2011; Karas et al., 2013). In Russia, 523 member banks of the deposit insurance system failed over 2004–2020, affecting nearly 10 million depositors[8].

Deposit insurance enables citizens to delegate responsibility for their financial decisions to the government. It reduces the incentive to discipline banks (Demirgüç-Kunt and Huizinga, 2004; Karas et al., 2010; Allen et al., 2015; Calomiris and Jaremski, 2018). Consequently, opportunistic behavior becomes rational. Depositors learn how to take advantage of the system by repeatedly choosing the riskiest banks, maximizing interest revenue until the bank fails and then collecting full compensation. Attempts at unbiased cost-benefit analysis are surprisingly rare in the literature. The aggregate social cost of deposit insurance includes explicit (Hogan and Luther, 2014) and implicit costs (Hogan and Luther, 2016).

Schemes are co-funded by their participants. Given that 75 percent of all household deposits in Russia are with state-owned banks[9], the state makes a significant contribution to funding Russia's scheme. Cumulative disbursement from the deposit insurance fund over 2004–2019 (RUB 2 trillion) is double the amount of bank contributions to the fund (RUB 1 trillion). Under a shortage of funds, the back-stop provision allows public funds to be injected into the deposit insurance system. The Russian system faced a shortfall of funds in 2015 after a series of large disbursements that were unmatched by bank contributions. What was originally an implicit liability, became a financial one for the monetary authorities. The Central Bank of Russia lent RUB 842 billion in 2015–2017[10], in order to prevent the imminent insolvency of the Deposit Insurance Agency. The bail-out loan from the Central Bank is recoverable over time, but its net present value is negative due to its long maturity and low interest rate. Thus, there is a net loss of public funds, which is neither recognized as public expenditure nor subject to parliamentary scrutiny. It is a quasi-fiscal operation. Ultimately, everyone contributes, including those without a bank account or savings, i.e., those who do not consume the merit commodity.

Deposit insurance has distributional effects. Some depositors receive more interest revenue from relatively unsafe banks than they would otherwise earn at safe banks. The depositors with safe

[8] Data published by the Deposit Insurance Agency of Russia, https://www.asv.org.ru/agency?news-tags=&news-date=all.

[9] Calculated by the author on the basis of data from the Central Bank of Russia, https://www.cbr.ru/eng/about_br/publ/nadzor/

[10] https://www.asv.org.ru/agency/for_press/pr/613325/

banks (e.g., state-owned and foreign-owned ones) receive less interest income from banks that make compulsory contributions to the deposit insurance fund (Vernikov, 2020). Some bank owners and top managers steal people's deposits (Calomiris and Jaremski, 2018) or misuse them in other ways. Hardly any other industry can match banking in the ability to privatize profits and socialize losses. Payments to creditors of fraudulent, collapsed banks are mostly irrecoverable. Several such banks were dealt with by the Central Bank of Russia, bypassing the deposit insurance system. This doubles the total of state-funded pay-outs to depositors that result from the liability undertaken by the government as guardian of citizens' deposits.

Negative effects may stem from the faulty design and implementation of a deposit insurance scheme. For instance, Russia's scheme emerged prematurely, in the absence of key legal and other institutions. The government extended protection to nearly 1,000 banks, many of which were weak, small and crime-ridden. Banking supervision and regulation was still inadequate. Predictably, the contributions of depositors with sound banks were used to satisfy the depositors with unsound ones. Such negative effects are partly avoidable with a better-designed scheme. It needs not be exactly the same as in the United States, whose institutional environment is very different. If the bulk of household deposits were lodged with state-owned banks[11], one could avoid duplication of government liabilities and excessive moral hazard. Insurance would then cover private bank depositors, thus minimizing the financial exposure of the government.

4. Genuine merit or false merit

4.1. Meritorious intervention into deposit-taking

The ignorance argument

Ignorance as one of the reasons for meritorious intervention finds conflicting evidence in the case of bank deposits. It does take an effort to obtain information about a bank, but the cost of information in terms of time and money has, over time, become negligible, as detailed bank data are disclosed free of charge via the Internet by the bank or its supervisory agency or both. Understanding bank information requires skills that a 'lay person' may miss.

It matters whether depositors *want* such information. In theory, they do – they discipline banks and penalize them for poor performance and excessive risk by withdrawing deposits or requiring a higher interest rate (Martínez-Pería and Schmukler, 2001). In practice, they may choose ignorance, instead of gathering and digesting available information on bank quality. One might presume that every active bank with a valid license is creditworthy.

There are various types of signals regarding bank soundness. Empirical studies suggest that depositors do discriminate between banks quality-wise and perceive an above-market interest rate to be a reflection of unobservable risk in a bank. Thus, the weaker the bank, the higher the interest rate it offers (Maechler and McDill, 2006; Ungan et al., 2008; Karas et al., 2010). In the event of a bank run, uninsured banks with bad fundamentals suffer more severe deposit outflows than those with good fundamentals (De Graeve and Karas, 2014). Depositors move money around and adjust their investment strategies to the changes in bank ownership structure (Atmaca et al., 2020).

The perils of trusting bank advertising in the retail deposit market raises an argument referred to in theoretical literature as the 'weakness of will of Ulysses'[12] (Elster, 1985; Tietzel and Müller, 2002). Unlike the sailors of Ulysses, bank depositors would not plug their ears with wax to avoid listening to the [potentially fatal] attractive price offers from unsound banks. Such banks advertise aggressively because they intend to misuse private deposits before failing and leaving behind a heap of creditor claims. The government imposes higher deposit insurance fund charges on risky banks promising unrealistic interest. Interestingly, in such cases, a deposit becomes more of a de-merit commodity carrying abnormal risk – for the deposit protection scheme, in the first place. Paternalistic intervention manages to steer individuals away from such risk, even though individuals are prepared to take this risk.

---

[11] The credibility of implicit government guarantee is questionable. In 1998, *Sberbank* suffered some depositor runs (Pyle et al., 2012).

[12] According to the Greek myth, Ulysses wanted to hear the enticing song of the Sirens, but had himself bound to the mast of the ship in order to be able to withstand it.

The 'ignorance' argument is, therefore, questionable with respect to bank deposits. Depositors mostly do know which bank is good and which is not.

The irrationality argument

Depositor runs can, in fact, be irrational as well as rational. Withdrawing uninsured funds without delay from an ailing bank is rational; it is part of the mechanism of market discipline (Demirgüç-Kunt and Huizinga, 2004). Conversely, one might doubt the rationality of keeping – or willfully placing – money in overly risky, unsound banks. Distorting natural rationality of economic agents is the effect of deposit insurance on individuals.

(Un)availability of private solutions

Economic history has seen many fully- or mostly-private deposit guarantee schemes since the nineteenth century in the United States. There is also ample evidence of how they failed or became insolvent due to mismanagement, fraud ('deposit stealing') or both of the latter (Thies and Gerlowski, 1989; Calomiris and Jaremski, 2018). In the 1930s, "*as private forms of insurance collapsed, the middle classes threw their considerable political weight behind the extension of social insurance and the creation of what would later be called the welfare state*" (Rodrik, 2000: 9).

The majority of contemporary deposit protection schemes are run by governments, co-financed with public funds, and rely on the government as a back-stop under a shortage of funds. Government involvement in deposit guarantee schemes is, generally, substantial. By the end of 2013, 73 explicit deposit insurance schemes were administered publicly, 25 jointly and only 13 privately. While a small minority of these schemes are funded directly by the government, 42 national systems provide a back-stop, i.e., in the event of a shortfall of funds, they can issue bonds, receive loans guaranteed by the government and access funding from the central bank or ministry of finance[13] (Demirgüç-Kunt et al., 2015: 176). Deposit guarantee has become one of the major categories of bank regulatory and supervisory policies, along with: entry regulation; ownership restrictions; capital standards; external auditing requirements; liquidity requirements; and asset classification, etc. (Barth et al., 2013).

4.2. Private interest

It is important to identify properly a public want and the goods that can satisfy it, in the case under examination. Financial or monetary stability or smooth functioning of the payment system might indeed be a public want and good. It is actually 'consumed' by individuals in varying amounts proportional to their risk exposure, i.e., the size of the deposit at stake. Politicians apply deposit guarantee to attain stability. Private bank deposit is the commodity the supply of which is regulated by deposit guarantee in order to ensure the solvency and sustainability of banks. Neither a private bank deposit nor a deposit guarantee qualifies for a public good. Deposit-taking by banks involves private agents in a competitive industry, each pursuing its own private utility and benefit. Individual savings are perfectly private, at least, under capitalism. Retail bank ownership is predominantly private in most industrialized nations, including transition economies.

It is not a novelty that laws and regulations that shape the structure of the banking industry are strongly influenced by the banking community or some of its factions. For several decades, the stakeholders of smaller unit banks have been delaying the inevitable and much needed restructuring of the industry in the US (White, 1982). When the supporters of deposit insurance exploit the social want of financial stability, there are vested interests. Although many policymakers and economists are convinced that "*deposit insurance was adopted* [in the United States. – *the Author*] *purely out of public interest to guarantee the stability of the banking system, it actually was because of the success of a very narrow group of special interests that wanted to tilt the structure of the financial system in their favor*" (White, 1997).

[13] Legalities notwithstanding, *all* national deposit insurance schemes are highly likely to receive a state bail-out in the event of a shortfall of funds, for precisely the same reasons that explain the existence of deposit insurance. Consequently, a hard budget constraint would not be credible.

Depositors with privately-owned banks receive relatively high interest income on their insured investments without paying a realistic premium for the related risk. Owners and top managers of these banks benefit by gaining access to funding sources which would otherwise be unavailable to them. Deposit insurance lowers the price that deposit-takers have to pay. The outcome of mismanaging liquidity risk, credit risk and other types of banking risks is externalized.

At the end of the day, deposit protection bails out certain groups of depositors, which is tantamount to a misallocation of resources. Deposit guarantee fails to fully pass the tests of non-rival, non-diminishable or non-excludable consumption that is inherent to public goods. There is a ceiling on insured deposits, so large depositors will be partially excluded. Bank runs and banking crises occur because depositors know that only some of the creditor claims can be satisfied. In a similar fashion, no guarantee fund can cover all insured deposits, and in the worst-case scenario some of the insured depositors will get full compensation while some others will only get a partial one. The financial capability of a deposit insurance fund is related to the amount of injection that local fiscal authorities can realistically make in case of shortage of funds. In many countries, the aggregate of private deposits exceeds by a factor the entire national budget. Inflationary financing for that purpose would have consequences in terms of a decreasing purchasing power of funds recovered by affected depositors.

There are institutions aimed to maintain social order, particularly during transition, such as poor relief systems. Deposit insurance can theoretically be viewed from the same perspective. However, the British poor relief system was originally "*designed and mainly applied to provide for those who were unable to provide for themselves. Among them were the elderly, the insane, the disabled, the homeless (known as 'vagabonds and vagrants' at the time), and households headed by women*" (Greif and Mokyr, 2016: 34). Bank depositors might qualify some of these categories such as elderly or disabled. On average, however, bank depositors are better off than the rest of the population with no savings at all. So, deposit guarantee is rather mass-affluent relief than poor relief. Depositors feel more secure. More specifically, some private depositors feel more secure at the expense of other private depositors and public funds.

Paternalistic rhetoric of the politicians concerning deposit guarantee may serve as a smokescreen for other purposes. In the Russian case, one goal was macro-economic, namely to fund private banks with household savings. Another goal was to break up the monopoly of state-owned banks by boosting confidence in uncompetitive smaller privately-owned banks broadly mistrusted by the public (Vernikov, 2019).

At present, deposit protection yields benefit primarily for mass affluent consumers in big cities, or the upper middle class, which is consistent with the Director's law on public income redistribution (Stigler, 1970). For instance, evidence from Russia suggests that, contrary to official propaganda, the main beneficiaries of the deposit guarantee are neither small savers ('laypeople') nor vulnerable social groups. The coverage limit (RUB 1.4 million per depositor per bank) is 7 times larger than the average size of a household deposit nationwide (RUB 200,800). Those who collected the average deposit insurance of RUB 634,000 in 2017[14], were not poor, by Russian standards.

4.3. Quasi-merit goods

The choice of merit goods deserving public support does emerge from political processes (Brennan and Lomasky, 1983). It is, however, fanciful to assume that the political process and mechanism will always be fully efficient in revealing public wants. Complete and accurate information may be unavailable. Public choice is not immune from manipulation and interference by interest groups (Olson, 1965) even in a mature democracy, not to mention emerging market economies. It is especially true when substantial public funds are at stake. Each nation decides for itself which commodity deserves public support and which does not. My concept does not challenge the outcome but refers to the process of choice. The above-mentioned private bank deposits set an example how private interest can successfully disguise as a public one in order to demand government intervention.

[14] Calculated by the author using Deposit Insurance Agency data.

By *quasi-merit good*, I mean a commodity that is not fully deserving of merit and acquires it unjustifiably. The prefix *pseudo-* (from Greek ψευδής, 'lying' or 'false') has the advantage of wide usage in various academic fields. At the same time, the prefix *quasi-* appears in the term 'quasi-public goods' which refers to a phenomenon related to the one described in this paper. Roads, tunnels and bridges are typical quasi-public goods which "…*have characteristics of both private and public goods, including partial excludability, partial rivalry, partial diminishability and partial rejectability*"[15]. Quasi-public goods, thus, share some feature with genuine public goods but fall short to be qualified as such. In a similar vein, some private goods obtain the status of merit goods via a political process, albeit by means of manipulation, lobbying, misinformation, etc. I would propose to designate them 'quasi-merit goods', be it for the sake of consistency with the existing term 'quasi-public goods'.

Bearing in mind the nature of quasi-merit goods, I would place them between private goods and merit goods (chart).

Chart. The relative position of quasi-merit goods

Source: Author.

Such positioning reflects the fact that quasi-merit goods are essentially private goods. What makes them different is that special interests seek for them public protection in virtue of their presumably meritorious nature. Like other private goods and genuine merit goods, they are – to a varying degree – rival, diminishable, excludable and rejectable.

The notion of quasi-merit goods does not compete with the notion of de-merit goods. De-merit goods are the opposite of merit goods; their consumption is deemed to bring about negative externalities, despite ongoing market demand for such goods, which stems from the public's 'weakness of will'. It does not apply to quasi-merit goods the consumption of which is not associated with negative externalities, so the government does not discourage such consumption via nudging nor any other means.

Taking from the case of bank deposits, I would list a few tentative *criteria* which might help identifying quasi-merit goods:

- The commodity is, through economic history, privately produced, delivered and consumed.
- Protection is sought on the assumption that a commodity satisfies a public want, while in reality it advances identifiable private interests.
- Abnormal activity by pressure-groups to promote the issue within the political agenda.
- High explicit costs (public expenditure) and implicit ones (moral hazard, price distortions, etc.); their unfair distribution.
- Availability of alternative solutions with less state involvement.

The case of bank deposits may be not unique. It would take separate case studies to find out whether a state-sponsored private commodity is a genuine merit good or a quasi-merit good. One immediate candidate for such a scrutiny comes to mind these days, and that is a COVID-19 vaccine. All these vaccines are 'consumed' privately, and most of them are produced privately. Governments buy them and deliver them to citizens for free, in view of the expected positive externalities in terms of public health, employment, output, national security, etc. What calls particular attention, though, are the skyrocketing profits of the pharmaceutical companies involved, as well as the abnormally pushy lobbying by pressure groups, against the backdrop of claims about questionable efficacy of the vaccines and their potential side-effects.

5. Conclusion

The idea of quasi-merit goods is derived from the concept of merit goods by Richard A. Musgrave. I introduce the notion of quasi-merit goods to designate private commodities for which meritorious treatment is sought from the government. Pressure groups make society believe that the consumption of

[15] https://www.economicsonline.co.uk/definitions/quasi_public_good.html

these commodities serves the public interest and that there is no viable alternative to government intervention. The claim is partly or wholly false. Quasi-merit goods imply bounded rationality within human behavior and raise the 'ignorance' argument. The main difference with genuine merit goods is that a private solution is feasible. The protection of quasi-merit goods leads governmental policy astray and reallocates public resources from genuine merit goods.

The paper contains a brief case study explaining the author's theoretical concept. It is argued that private bank deposits are one of the quasi-merit goods. While a steady flow of household savings to financial organizations serves the public interest, government intervention in a private matter between a bank and its customers relies on the usual arguments of 'ignorance', irrationality, a lack of private solutions, etc. Deposit guarantees are marketed to the general public as protection of 'laypeople' from risks bearing serious economic consequences that the layperson, presumably, could not manage. Public choice is, thus, manipulated, because the main justifications are only partly genuine. Motivated depositors know how to monitor and discipline their banks. In reality, intervention primarily assists banks in their liquidity risk management and indirectly subsidizes private deposit-takers. Nevertheless, contemporary governments are spearheading the establishment of deposit protection schemes and spending public money to ensure that they remain solvent. Society pays a heavy toll for having deposit insurance in place, in terms of both explicit and implicit costs, which are unfairly distributed. It is mass affluent consumers in big cities, and not small savers, who benefit most, together with the insiders of privately-owned banks who abuse household deposits. The excessive social cost is due to the faulty design and implementation of deposit protection schemes.

This paper does not claim that any deposit insurance is wrong in itself (although it might be). Nor it makes a judgment regarding the appropriateness of the specific deposit insurance scheme for each country. I only imply that private bank deposits deserve paternalistic protection and intervention less than is commonly believed. A related point is that private interests drive the adoption of deposit protection schemes, on the pretext of serving the public good of financial stability. A nonmarket institution "*may actually exacerbate the market failure*" (Stiglitz, 1989: 197), instead of ameliorating it. Deposit protection might be a case in point.

There are two directions for future research: (1) to polish the concept of quasi-merit goods to ensure its consistency with contemporary extensions of public finance theory; and (2) to examine additional commodities that qualify as candidates for the category of quasi-merit goods.

References

Allen F., Carletti E., Goldstein I., Leonello A. (2015). Moral hazard and government guarantees in the banking industry. *Journal of Financial Regulation* **1**(1): 30–50.

Arcelus F., Levine A. (1986). Merit goods and public choice: The case of higher education. *Public Finance = Finances publiques* **41**(3): 303–315.

Atkinson A. (1987). The collected papers of Richard A. Musgrave. A review article. *Journal of Public Economics* **33**: 389–398.

Atmaca S., Kirschenmann K., Ongena S., Schoors K. (2020). *Deposit insurance, bank ownership and depositor behavior*. ZEW Discussion Paper No. 20-077.

Barone E. (1959). On public needs, pp. 165–167. In: R.A. Musgrave (ed.) *The Theory of Public Finance*. N.Y.-L.: McGraw-Hill.

Barth J., Caprio G., Levine R. (2013). Bank regulation and supervision in 180 countries from 1999 to 2011. *Journal of Financial Economic Policy* **5**(2): 111–219.

Baumol W. (1993). Social wants and dismal science: The curious case of the climbing costs of health and teaching. *Proceedings of the American Philosophical Society* **137**(4): 612–637.

Beckerman W. (1986). How large a public sector? *Oxford Review of Economic Policy* **2**(2): 7–24.

Brennan G., Lomasky L. (1983). Institutional aspects of "merit goods" analysis. *FinanzArchiv / Public Finance Analysis* **41**(2): 183–206.

Brennan G., Buchanan J. (1985). *The Reason of Rules*. N.Y.: Cambridge Univ. Press.

Bryant J. (1980). A model of reserves, bank runs, and deposit insurance. *Journal of Banking and Finance* **4**(4): 335–344.

Buchanan J. (1960). The theory of public finance. *Southern Economic Journal* **26**(3): 234–238.

Calomiris Ch. (1999). Building an incentive-compatible safety net. *Journal of Banking and Finance* **23**(10): 1499–1519.

Calomiris Ch., Jaremski M. (2018). Stealing deposits: Deposit insurance, risk-taking, and the removal of market discipline in early 20th century banks. *Journal of Finance* **74**(2): 711–754.

Chernykh L., Cole R. (2011). Does deposit insurance improve financial intermediation: Evidence from the Russian experiment. *Journal of Banking and Finance* **35**(2): 388–402.

De Graeve F., Karas A. (2014). Evaluating theories of bank runs with heterogeneity restrictions. *Journal of the European Economic Association* **12**(4): 969–996.

Demirgüç-Kunt A., Huizinga H. (2004). Market discipline and deposit insurance. *Journal of Monetary Economics* **51**: 375–399.

Demirgüç-Kunt A., Kane E., Laeven L. (2008). Determinants of deposit insurance adoption and design. *Journal of Financial Intermediation* **17**(3): 407–438.

Demirgüç-Kunt A., Kane E., Laeven L. (2015). Deposit insurance around the world: A comprehensive analysis and database. *Journal of Financial Stability* **20**: 155–183.

Diamond D., Dybvig Ph. (1983). Bank runs, deposit insurance, and liquidity. *Journal of Political Economy* **91**(3): 401–419.

Dworkin G. (2019). "Paternalism". In: E. Zalta (ed.) *The Stanford Encyclopedia of Philosophy*.

Elster J. (1985). Weakness of will and the free rider problem. *Economics and Philosophy* **1**(2): 231–265.

Greif A., Mokyr J. (2016). Institutions and economic history: a critique of professor McCloskey. *Journal of Institutional Economics* **12**(1): 29–41.

Grinberg R., Rubinstein A. (2005). *Economic Sociodynamics*. N.Y.: Springer.

Head J. (1966). On merit goods. *FinanzArchiv / Public Finance Analysis* **25**(1): 1–29.

Hogan T., Luther W. (2014). The explicit costs of government deposit insurance. *Cato Journal* **34**(1): 145–170.

Hogan T., Johnson K. (2016). Alternatives to the Federal Deposit Insurance Corporation. *Independent Review* **20**(3): 433–454.

Hogan T., Luther W. (2016). The implicit costs of government deposit insurance. *Journal of Private Enterprise* **31**(2): 1–13.

Karas A., Pyle W., Schoors K. (2010). How do Russian depositors discipline their banks? Evidence of a backward bending deposit supply function. *Oxford Economic Papers* **62**(1): 36–61.

Karas A., Pyle W., Schoors K. (2013). Deposit insurance, banking crises, and market discipline: Evidence from a natural experiment on deposit flows and rates. *Journal of Money, Credit and Banking* **45**(1): 179–200.

Keely M. (1990). Deposit insurance, risk and market power in banking. *American Economic Review* **80**(5): 1183–1200.

Maechler A., McDill K. (2006). Dynamic depositor discipline in US banks. *Journal of Banking and Finance* **30**: 1871–1898.

Martínez-Pería M., Schmukler S. (2001). Do depositors punish banks for bad behavior? Market discipline, deposit insurance, and banking crises. *Journal of Finance* **56**(3): 1029–1051.

Musgrave R. (1957). A multiple theory of budget determination. *FinanzArchiv / Public Finance Analysis* **17**(3): 333–343.

Musgrave R. (1959). *The Theory of Public Finance*. N.Y.-L.: McGraw-Hill.

Musgrave R. (1987). Merit goods, pp. 452–453. In: *The New Palgrave: A Dictionary of Economics*, vol. 3.

Musgrave R. (1996). The role of the state in fiscal theory. *International Tax and Public Finance* **3**: 247–258.

Olson M. (1965). *The Logic of Collective Action: Public Goods and the Theory of Groups*. Cambridge: Harvard University Press.

Prest A. (1959). The theory of public finance by R. A. Musgrave (Review). *Economic Journal* **69**(276): 766–770.

Pyle W., Schoors K., Semenova M., Yudaeva K. (2012). Depositor behavior in Russia in the aftermath of financial crisis. *Eurasian Geography and Economics* **53**(2): 267–285.

Rodrik D. (2000). Institutions for high quality growth: What they are and how to acquire them. *Studies in Comparative International Development* **35**(3): 3–31.

Stigler J. (1970). Director's law of public income redistribution. *Journal of Law and Economics* **13**(1): 1–10.

Stiglitz J. (1989). Markets, market failures, and development. *American Economic Review* **79**(2): 197–203.

Stiglitz J. (2009). The current economic crisis and lessons for economic theory. *Eastern Economic Journal* **35**: 281–296.

Tanzi V. (2011). *Government versus Markets: The Changing Economic Role of the State*. Cambridge University Press.

Thaler R. (1980). Toward a positive theory of consumer choice. *Journal of Economic Behavior and Organization* **1**(1): 39–60.

Thaler R., Sunstein C. (2003). Libertarian paternalism. *American Economic Review* **93**(2): 175–179.

Thies C., Gerlowski D. (1989). Deposit insurance: A history of failure. *Cato Journal* **8**(3): 677–693.

Tietzel M., Müller Ch. (2002). Merit goods from a constitutional perspective, pp. 375–400. In: G. Brennan, H. Kliemt, R. Tollison (eds.) *Method and Morals in Constitutional Economics*. Springer-Verlag Berlin Heidelberg.

Ungan E., Caner S., Özyıldırım S. (2008). Depositors assessment of bank riskiness in the Russian Federation. *Journal of Financial Services Research* **33**(2): 77–100.

Ver Eecke W. (ed.) (2007). *An Anthology Regarding Merit Goods: The Unfinished Ethical Revolution in Economic Theory*. Purdue Univ. Press: West Lafayette, IN.

Vernikov A. (2019). The drivers of institutional change in a post-socialist economy: The case of deposit insurance introduction in Russia. *Journal of Institutional Studies* **11**(1): 129–143. DOI: 10.17835/2076-6297.2019.11.1.129-143

Vernikov A. (2020). Deposit protection in a paternalistic state: The Russian case. *Terra Econ.* **18**(1): 28–42. DOI: 10.18522/2073-6606-2020-18-1-28-42

White E. (1982). The political economy of banking regulation, 1864–1933. *Journal of Economic History* **42**(1): 33–40.

White E. (1997). Deposit insurance, pp. 85–100. In: G. Caprio, D. Vittas (eds.) *Reforming Financial Systems: Historical Implications for Policy*. Cambridge, UK: Cambridge Univ. Press.

White M. (2019). Nudging merit goods: Conceptual, normative, and practical connections. *Forum for Social Economics* **48**(3): 248–263.