December 2012

Meir Statman

The Global Financial Crisis: Wants, Values, Fairness, and Culture in Behavioral Finance


“After 12 months of hard work dismantling the company,” wrote DeSantis, “during which A.I.G. reassured us many times we would be rewarded in March 2009 — we in the financial products unit have been betrayed by A.I.G. and are being unfairly persecuted by elected officials.”

“In response to this, I will now leave the company and donate my entire post-tax retention payment to those suffering from the global economic downturn.”

DeSantis’ post-tax retention payment was $742,006.40

“My hard work earned me acceptance to M.I.T., and the institute’s generous financial aid enabled me to attend. I had fulfilled my American dream.”

“The profitability of the businesses with which I was associated clearly supported my compensation. None of us should be cheated of our payments any more than a plumber should be cheated after he has fixed the pipes but a careless electrician causes a fire that burns down the house.”

We want three benefits in life, described by Statman (2011), utilitarian, expressive, and emotional. And we want to avoid their costs. DeSantis’ letter touched on all three.
Utilitarian benefits are the answer to the question, What does it do for me and my pocketbook? The utilitarian benefits of watches include time telling, the utilitarian benefits of restaurants include nutritious calories, and the utilitarian benefits of jobs are mostly income, whether wages, salaries, bonuses or retention payments. DeSantis’ job brought him a salary, a $742,006.40 post-tax retention payment, and a promise of a bonus for “12 months of hard work dismantling the company.”

Expressive benefits convey to us and to others our values, tastes, and status. They answer the question, What does it say about me to others and to me? Titles, whether Chairman, Chief Executive, or DeSantis’ title of Executive Vice President express status and esteem, including self esteem. Self esteem also comes from adhering to our values, including the value of reaching the American Dream by hard work. DeSantis “was raised by schoolteachers working multiple jobs in a world of closing steel mills.” Hard work, not luck or a generous inheritance, earned him an M.I.T. degree and the American Dream.

Values include fairness. DeSantis believes that he has treated A.I.G. fairly, working “10, 12, 14 hours a day away from my family” at an annual salary of $1 and a promise of a bonus. But now he finds that he is treated unfairly, “betrayed by A.I.G. and…being unfairly persecuted by elected officials.”

Emotional benefits are the answer to the question, How does it make me feel? The title of Executive Vice President and an M.I.T. degree made DeSantis feel proud. Keeping his promise to work long days at A.I.G. made DeSantis feel honest. Betrayal by A.I.G. and the government made DeSantis feel angry. And the $742,006.40 contribution to charity made him feel righteous.
We are often willing to sacrifice utilitarian benefits for expressive and emotional ones. We boycott stores that treat their employees unfairly even when we pay higher prices at other stores, and we turn down offers we consider unfair. This is evident in ultimatum games where person A makes an ultimatum offer for the division of an amount, say $1,000, between himself and person B, perhaps $500 to each, or perhaps $950 to himself and $50 to B. B can accept or reject the ultimatum offer, but not negotiate. If B accepts the ultimatum offer, A and B receive shares of the $1,000, as specified in the ultimatum offer. But neither A nor B receive anything if B rejects the ultimatum offer.

It turns out the players B regularly reject offers as high as $200 because they consider them unfair. Players B lose the utilitarian benefits of $200 but gain the expressive and emotional benefits of protesting the unfairness of persons A by depriving them of $800. DeSantis must have gained expressive and emotional benefits exceeding the utilitarian benefits of $742,006.40 by contributing the money to charity.

Some readers of DeSantis’ letter agreed with him. One wrote: “Mr. DeSantis and AIG entered into a voluntary contract between two private parties. The sanctity of private contracts is a cornerstone of our nation, whether you as a third party like what's in the contract or not.” Another wrote: “This man went to MIT, one of the hardest institutions in the country, if not in the world. If you graduated with an advanced degree from MIT and chose a profession that pays well, then wouldn't you deserve rightful pay? So yeah, some professions pay more than others - it's life. If you aren't happy with your salary, go back to school and choose a new career path.”
Many more readers disagreed, some mocking, some sad, and some angry. One wrote: “My first impression… was that DeSantis must certainly be a fictional character created…for entertainment, but then I realized there are actually people out there who command large salaries, yet have the emotional maturity of a 16-year-old boy demanding a new Corvette from his father for his first car.” Another wrote: “I'm very sorry for Mr. DeSantis' loss. As sorry as a single mother with a less than $50K salary who filed bankruptcy three months ago can be…” And yet another wrote: “OK, Jake, I'm going to say it again: NOBODY deserves to be paid $700,000 for a year's work. It's an obscenely huge amount of money that can have no relationship to the work actually done. Even if you had worked 24-7 it would be too much. The only reason you and your ilk have been able to lay claim to that much loot has been that you all were smart enough to rig the game in your favor and elect your henchmen to political office while hoodwinking a gullible public into believing they too would profit by the game. The game is over now, and the reasoning supporting excessive compensation has been exposed as a lie. You guys weren't the best and the brightest, you were failures, cheats; you are not a rare commodity, you are in fact a dime a dozen; and you can easily be replaced by people who will do an honest day’s work for honest pay. So slink off to whatever chateau you acquired with your ill-gotten gains, lock the gates and sulk. We are happy to get rid of you.”

DeSantis’ letter and readers’ reactions to it raise many questions. Is it fair to renege on a contract? Is it just to earn $700,000 in one year? Is it right to use taxpayers money to help the poor buy houses or pay bonuses to the rich? Is it fair to subsidize philanthropy
with tax deductions while letting philanthropists decide where the money would go, whether homes for operas or homes for homeless?

Is it right to attribute our success solely to our efforts, or is it proper to attribute some of it to the society in which we live, or even to luck? Is it fair to designate some poor as undeserving poor and some as deserving? And is it fair to designate some rich as undeserving rich and some as deserving?

Many have offered conflicting answers to these questions in the depth of the financial crisis and more recently, highlighted during the election campaigns of 2008, 2010, and 2012. These questions are at the center of this article.

**Fairness rights**

Freedom from coercion is one of seven fairness rights discussed by Shefrin and Statman (1992, 1993), and equal bargaining power is another. The fairness right of freedom from coercion entitles people to be free from coercion as they choose to enter into contracts or refrain from entering. By that fairness right, contracts are fair when people enter into them voluntarily and transactions are fair if people engage in them voluntarily. DeSantis felt entitled to the right of freedom from coercion and so did the reader of DeSantis’ letter who noted that “Mr. DeSantis and AIG entered into a voluntary contract between two private parties.” The fairness right of freedom from coercion underlies much of advocacy for free markets and libertarian policies.

The fairness right of equal bargaining power entitles people to equal power in negotiations leading to contracts or transactions and equal power in making subsequent changes in contracts or transactions. The right to equal bargaining power underlies
advocacy of income redistribution, set minimum wages, and programs that help the poor buy houses.

Fairness rights compete with other fairness rights and claimants of each fairness right compete with other claimants of the same right. Even the relatively powerful, such as DeSantis, can conclude that their right to equal bargaining power had been violated. DeSantis is powerless relative to the government and A.I.G., reduced to protesting that he had been “betrayed by A.I.G.,” and “unfairly persecuted by elected officials.” Taxpayers, on DeSantis’ opposite side, protest that it is their rights to freedom from coercion and equal bargaining power that had been violated. The government bailed out A.I.G. with taxpayer money that funded DeSantis’ retention payment and was about to pay his bonus.

DeSantis surely expected empathy from readers of his resignation letter, fellow victims of the financial crisis, including plumbers, schoolteachers, and retirees. Why would it matter if his after-tax retention pay amounted to $740,000 and that the bonus he was deprived of would have added hundreds of thousands more? After all, as he wrote, “None of us should be cheated of our payments any more than a plumber should be cheated after he has fixed the pipes but a careless electrician causes a fire that burns down the house.”

DeSantis’ views resemble those of many of his fellow finance professionals, whether bankers, traders, managers of hedge funds, and partners in private equity firms. As Statman (2004) noted many finance professionals behave as if they live in a cocoon, where retention payments and bonuses in the hundreds of thousands or millions are ordinary and fair. Finance professionals often maintain the naïve belief that their own views are shared by all. They are not. Fairness rights are an outcome of a process that involves the entire
community, not finance professionals alone, and the views of many in the community are radically different from the views of finance professionals.

Finance professionals face both internal and external obstacles to following community rules of fairness. The internal obstacle is these professionals’ adherence to a free-market notion of fairness, where freedom from coercion is the sole fairness right and the right to equal bargaining power is dismissed. The external obstacle is the difficulty of explaining the social benefits of finance professionals, compared to the ease of explaining the social benefits of physicians, engineers, or plumbers.

DeSantis’ plumber analogy exposes his life in the cocoon. One reader of his letter wrote: “Mr. DeSantis’ self-pitying letter shows just how far removed he is from his rustbelt roots. Mr. DeSantis wishes us to see him as a hard working man, like a plumber, who has not been paid for plumbing work because an electrician has burned down the building the plumber was working on. This spurious analogy is supposed to shame the president of A.I.G., Congress and the American public for requesting that he forgo his 1+ million pre-tax bonus because his company's gross financial malpractice has greatly contributed to the onset of the worst economic downturn since the Great Depression. Well, shame on you Mr. DeSantis.”

Both the Tea Party and the Occupy Wall Street movements were triggered by claims of their adherents that their rights to freedom from coercion and equal bargaining power have been violated. Rick Santelli, CNBC Business News editor, is credited by some for sparking the Tea Party. In a broadcast from the floor of the Chicago Mercantile Exchange on February 19, 2009, Santelli criticized a government plan to refinance
mortgages. “How many of you people want to pay for your neighbors' mortgage that has an extra bathroom and can't pay their bills?” he angrily asked. “President Obama, are you listening?”

Weil (2010) quoted pollster Scott Rasmussen on the claims of the Tea Party, "They think federal spending, deficits and taxes are too high, and they think no one in Washington is listening to them..." Adherents of the Tea Party resent the violation of their fairness right of freedom from coercion, feeling coerced to pay for the bailout of defaulting homeowners and banks through taxes and deficits, and they resent the violation of their right to equal bargaining power, as “no one in Washington is listening to them.” Adherents of the Occupy Wall Street movement resent the violations of their right to freedom from coercion in the bailout of banks almost as much as adherents of the Tea Party resent it. They also resent the violation of their right to equal bargaining power, reflected in the slogan “We are the 99 percent,” protesting the vastly higher bargaining power of the 1 percent.

Wars of culture, values, and fairness rights

“America faces a new culture war,” wrote Arthur C. Brooks (2010), president of the American Enterprise Institute. This is a war between competing visions of values, fairness rights, safety nets, and income redistribution. “In one,” wrote Brooks, “America will continue to be an exceptional nation organized around the principles of free enterprise -- limited government, a reliance on entrepreneurship and rewards determined by market forces. In the other, America will move toward European-style statism grounded in expanding bureaucracies, a managed economy and large-scale income redistribution.”
“These visions are not reconcilable,” wrote Brooks. “We must choose.”

Brooks noted differences between visions of values and fairness rights generally accepted in the cultures of United States and Europe and highlighted their effects on income redistribution. These different visions were evident during the 2008 presidential campaign when Joe Wurzelbacher, famous as Joe the Plumber, asked then Democratic candidate Barack Obama about small business tax policy. Obama’s response included the sentence, "when you spread the wealth around, it’s good for everybody," seized by many Republicans as evidence that Obama is a socialist, intending to redistribute wealth from rich to poor. During the 2012 campaign, Republican candidate Mitt Romney argued that income redistribution is already excessive, claiming that 47 percent of Americans prefer Obama over him because they "pay no income tax," "are dependent upon government" and "believe that they are entitled to health care, to food, to housing, to you-name-it." These different visions are also at the center of an analysis by Alesina and Angeletos (2003).

Alesina and Angeletos noted that redistribution of income from rich to poor in the United States is relatively meager, whereas it is relatively generous in continental Western Europe. They attributed the difference, at least in part, to different cultures, carrying different notions of fairness and social justice, reflected in different perceptions of the sources of income inequality. Typical Americans believe that wealth comes mostly from individual talent, effort, and entrepreneurship. In contrast, typical Europeans believe that wealth comes mostly from luck, connections, and corruption.

Alesina and Angeletos noted that the World Value Survey found that 71 percent of Americans believed that the poor could become rich if they just tried hard enough, whereas
only 40 per cent of Europeans shared that belief. Further, only 16 percent of Americans believed that income and success are mostly due to luck, whereas 25 percent of Europeans believed so. DeSantis is typically American in his perception of himself as a son of parents of modest means who became prosperous by hard work, not luck. A speech by President Obama during the 2012 campaign included the sentence “You didn't build that,” seized by Republicans as evidence that Obama dismisses the role of personal effort and hard work in economic success.

Alesina and Angeletos argued that the American and European systems of beliefs and redistribution policies can exist side by side. On one side of the Atlantic, the typical American belief that wealth comes mostly from effort rather than luck promotes policies of low taxes and meager redistribution. Consequently Americans, knowing that they would not be supported by the rich, exert great effort and accumulate more wealth, on average, than they would have accumulated if they had not exerted great effort. This perpetuates the belief that success comes mostly from effort. On the other side of the Atlantic, the typical European belief that wealth comes mostly from luck promotes policies of high taxes and generous redistribution from rich to poor. Consequently Europeans, knowing that they would be supported by the rich, exert little effort, accumulate little wealth. This perpetuates the belief that success comes mostly from luck.

The American and European systems can remain distinct from each other, each stable in its own equilibrium, but, as Brooks noted, the equilibrium is unstable. Zingales (2009) expressed his concern that the American system would soon resemble the European one. He wrote that “The nature of the crisis, and of the government’s response, now
threaten to undermine the public’s sense of the fairness, justice, and legitimacy of
democratic capitalism…the United States today risks moving in the direction of European
corporatism and the crony capitalism of more statist regimes.”

Zingales distinguished *pro-business* attitudes and policies from *pro-market*
attitudes and policies, arguing that pro-market attitudes and policies predominated before
the crisis but pro-business attitudes and policies endanger them today. Pro-market policies
promote free market competition. Anti-trust policies are one example, and so are policies
promoting low barriers to entry into markets, creation of new businesses, and creative
destruction, where new businesses destruct inefficient existing businesses that serve
consumers poorly. Pro-business policies, in contrast to pro-market policies, promote the
interests of existing businesses, restricting free-market competition and setting barriers to
entry into markets and creation of new businesses.

Zingales noted the unique American cultural notions of the self-made man and the
“American Dream,” counting Bill Gates, Michael Dell, Warren Buffett and Mark
Zuckerburg as prototypical American examples, contrasting them with the oligarchs in
Russia, Silvio Berlusconi of Italy, and Carlos Slim of Mexico, who thrive in countries
where governments grant monopolies to some and erect barriers to entry for others. Italian
managers, for example, rank “knowledge of influential people” first as best way to make
money. They rank “competence and experience” fifth.

DeSantis’ resignation letter reflects the American vision where effort determines
economic success and where the American Dream still beckons. “My hard work earned me
acceptance to M.I.T., and the institute’s generous financial aid enabled me to attend,”
wrote DeSantis. “I had fulfilled my American dream.” Yet DeSantis is curiously blind to the fact that he did not achieve his success entirely on his own. M.I.T.’s “generous financial aid” must have come from someplace, perhaps private donors and perhaps even taxpayers’ money channeled to M.I.T. through government grants. DeSantis’ blindness to the role of community effort in his success is common among Americans. Indeed, Obama did not dismiss the role of personal effort in economic success in the statement that included the sentence “you didn't build that.” He merely noted that success comes from a combination of personal effort and community effort. By implication, the community has the right to ask for a return on its effort, perhaps in the form of a strong safety net for the less successful. Obama said: “If you were successful, somebody along the line gave you some help. There was a great teacher somewhere in your life. Somebody helped to create this unbelievable American system that we have that allowed you to thrive. Somebody invested in roads and bridges. If you've got a business—you didn't build that. Somebody else made that happen.”

The analyses of Alesina and Angeletos and that of Zingales exaggerate the distinction between American and European cultural attitudes and policies and the magnitude of the changes in cultural attitudes brought about by the crisis. In truth, some Americans attribute economic success mostly to personal effort and some attribute it mostly to community effort or to luck, even if a higher proportion of Americans than Europeans attribute economic success mostly to personal effort than to community effort or luck. Warren Buffett, one of the people Zingales counts as representing the unique American notions of the self-made man, understand the role of community effort and luck
in his success, the role of government in helping people who have not been successful, and the fairness of sharing the fruits of success. Warren Buffett “believes in fairness,” wrote Foroohar (2012), following an interview with Buffett. “He believes in the ability of government to make people's lives better. But most of all, he believes in luck.” Buffett’s good fortune, he says, “starts with being born in this country.”

Moreover, pro-business policies in the U.S. have always existed, long before the recent crisis, regularly winning their battles against pro-market policies. Indeed, Stigler’s (1971) “capture theory” of decades ago is about governments captured by powerful interest groups. American governments regularly profess a desire to bolster the bargaining power of the relatively weak, such as bank customers, and restrain the power of the relatively strong, such as banks. Yet, as Stigler emphasized, the regulated often capture politicians and regulators and induce them, through campaign contributions and lucrative future jobs, to bolster their power further rather than restrain it. “Before the crisis, the consensus was that the Office of Thrift Supervision was the regulator most in the pocket of Big Banking,” wrote Eisinger (2012). That office was eliminated in the post-crisis regulatory overhaul. “Now, the title of ‘Most Captured’ is up for grabs, and I think that we have a contender,” said Simon Johnson, a former head economist for the International Monetary Fund and an outspoken critic of banks. That contender is the Office of Financial Research, created by the Dodd-Frank Act to conduct independent research on the financial system’s risks. But, noted Eisinger, the Office is not independent, as it is housed in the Treasury Department, its budget is small, and it reports to the regulators it is supposed to report on. Moreover, Eisinger counted only one of the 30 members of the advisory committee as a critic of the
financial services industry. In contrast, 19 members work directly in the financial services industry or for companies dependent on the industry. And many of the academics on the committee have lucrative ties to the financial services industry.

Deserving rich and undeserving ones

Zingales’ list of people exemplifying the unique American notions of the self-made man and the “American Dream” includes Bill Gates, Michael Dell, Warren Buffett, and Mark Zuckerberg, people who have gained their riches by individual talent, effort, and entrepreneurship. Zingales contrast them with the oligarchs in Russia, Silvio Berlusconi of Italy, and Carlos Slim of Mexico, who have gained their riches by connections, corruption, and luck.

Yet is seems curious that Zingales did not include in his list any American in finance, whether banker, hedge fund manager, or partner in a private equity firm. He not even phenomenally successful finance people who have accumulated great riches by individual talent, effort, and entrepreneurship such as Stephen Schwarzman, the Chairman and CEO of Blackstone, a private equity firm, Kenneth Griffin, the CEO of Citadel, a hedge fund, or Lloyd Blankfein, the Chairman and CEO of Goldman Sachs, an investment banking firm. Some might describe Warren Buffett who is on Zingales’ list as a finance person, but this is not how Buffett sees himself and how he is generally seen by others. In an interview with Sorkin (2012) Buffett said “The main thing I’m doing is trying to build a business…Investing is part of it but it is not the main thing.” When asked if there are any private equity investors he admires, “he flatly replied: ‘No’…When asked if he followed any hedge fund managers, he struggled to name any…”
There is a common feature in the Americans on Zingales’ list beyond individual talent, effort, and entrepreneurship, a feature that distinguishes ‘deserving rich’ from ‘undeserving rich.’ Deserving rich create win-win outcomes, where they create social benefits for others as they create riches for themselves. Undeserving rich, in contrast, create lose-win outcomes where they impose social costs for others as they create riches for themselves. Bill Gates, Michael Dell, and Mark Zuckerberg are deserving rich. Gates created social benefits in software that run computers, Michael Dell in affordable computers, and Mark Zuckerberg in an online community. The social benefits created by Stephen Schwarzman, Kenneth Griffin, and Lloyd Blankfein are not as obvious, even if they exist.

It is difficult to describe the social benefits provided by finance people to people on main street, a difficulty illustrated by Tom Wolfe’s (1987) depiction of Sherman McCoy, the “master of the universe” bond trader in his novel The Bonfire of the Vanities. In the following dialogue from the book, McCoy’s wife, Judy, tries to explain to their daughter, Campbell, how bond traders make their money. [Judy says] “Daddy doesn’t build roads or hospitals, and he doesn’t help build them, but he does handle the bonds for the people who raise the money.” [Campbell says] “Bonds?” [Judy says] “Yes. Just imagine that a bond is a slice of cake, and you didn’t bake the cake, but every time you hand somebody a slice of the cake a tiny little bit comes off, like a little crumb, and you can keep that.” Judy was smiling, and so was Campbell, who seemed to realize that this was a joke, a kind of fairy tale based on what her daddy did. “Little crumbs?” she said encouragingly. “Yes,” said
Judy. “Or you have to imagine little crumbs, but a lot of little crumbs. If you pass around enough slices of cake, then pretty soon you have enough crumbs to make a gigantic cake.”

Wolfe’s fictional story is so biting because it comes so uncomfortably close to reality. “Why did we get the bloated finance industry of today instead of the lean and efficient Wal-Mart?” asked Philippon (2012) …”why is the non-financial sector transferring so much income to the financial sector?” One simple answer, wrote Philippon, is that technological improvements in finance have mostly been used to increase trading. Yet Philippon found no evidence that increased trading brought social benefits. Securities prices are no more informative today than in earlier days when the volume of trading was much lower, and securities provide no better insurance or risk sharing today than in earlier days.

Greenwood and Sharfstein’s (2012) assessment of the social benefits of the finance industry is not as harsh as Philippon’s, but it is hardly all positive. They noted, first, that a large part of the growth of finance is in asset management, which provided social benefits in increased diversification and household participation in the stock market and in making it easier for young companies to raise funds. But the enormous growth of asset management after 1997 is accounted for by high fees for alternative investments, such as hedge and private equity funds, “with little direct evidence of much social benefit, and potentially large distortions in the allocation of talent.”

Second, Greenwood and Sharfstein noted changes that facilitated the expansion of household credit, mainly in residential mortgage credit. Yet they added that while there may be social benefits in expanding access to mortgage credit and lowering its cost, the
U.S. tax code already biases households to overinvest in residential real estate, and the shadow banking system that facilitated this expansion made the financial system more fragile.

Republicans are well-aware of the distinction between deserving rich and undeserving ones. They respond by labeling the rich as ‘job creators,’ implying that the rich provide social benefits to others beyond riches for themselves. Democrats are equally well-aware of the distinction. They have portrayed Republican presidential candidate Mitt Romney, a private equity manager, as a destroyer of jobs rather than as a creator. Stephen Schwarzman, a fellow private equity manager heading the Blackstone group, “made himself an easy target for critics of Wall Street greed and conspicuous consumption,” wrote Stewart (2008). “He lives in splendor in Manhattan, and he has an expanding collection of trophy residences that are lavish even by the current standards of Wall Street.” Schwarzman is aware of his image as an undeserving rich. “Why did this happen? We went public in June, 2007, at the top of a giant bull market, with a society undergoing rapid change. Globalization. Job dislocation. Middle-class anxiety. Private equity is seen as a symbol of the people who are prospering from a world in flux. That’s a lightning-rod situation.”

Wants of Utilitarian, expressive, and emotional benefits

Kahneman and Deaton (2010) distinguish emotional well-being from life-evaluation. “Emotional well-being refers to the emotional quality of an individual’s everyday experience—the frequency and intensity of experiences of joy, stress, sadness, anger, and affection that make one’s life pleasant or unpleasant. Life evaluation refers to

the thoughts that people have about their life when they think about it.” They found that the emotional well-being of people whose annual incomes exceed $75,000 is no higher than that of people whose income equals $75,000. But the life-evaluation of people continues to increase with socioeconomic status much past $75,000. People whose income is $750,000 report higher life-evaluation, on average, than people whose income equals $75,000.

Income, whether below $75,000 or above it, brings utilitarian benefits, but it also brings expressive and emotional benefits. Indeed, it is expressive and emotional costs that reduce emotional well-being for those earning less than $75,000. These are the expressive costs of low status, reliance on food stamps, and stress, as the poor struggle to find the money for electricity or car repairs.

Rich and poor strive for the expressive and emotional benefits of status and esteem, including self esteem, pride in their accomplishments, and satisfaction, even self-righteousness, in supporting their families. A reader of the Wall Street Journal wrote to its editor: “My children come first, but after barely making the president's "wealthy" threshold and taking care of those we love, and putting away for our children's education and for our retirement so we aren't a burden to other taxpayers, we cannot take a vacation by airplane unless we have frequent-flier miles. I am not complaining but explaining reality. We are proud of the way we have conducted ourselves and of the fiscal responsibility we display. We don't want what we don't earn. But we did earn what we have through hard work and long hours, and we would spend it more wisely than the government, thereby fueling this anemic economy.”
The expressive and emotional benefits of work and income are also evident in DeSantis’ letter. “I started at this company in 1998 as an equity trader, became the head of equity and commodity trading and, a couple of years before A.I.G.’s meltdown last September, was named the head of business development for commodities. Over this period the equity and commodity units were consistently profitable — in most years generating net profits of well over $100 million. Most recently, during the dismantling of A.I.G.- F.P., I was an integral player in the pending sale of its well-regarded commodity index business to UBS. As you know, business unit sales like this are crucial to A.I.G.’s effort to repay the American taxpayer.”

Expressive and emotional benefits vary with more than income and wealth. A university president with a $500,000 salary likely enjoys higher social status than an executive vice president of A.I.G with a $750,000 salary and a bonus on top. And the President of the United States whose annual salary is $400,000 surely enjoys higher social status than any university president.

The drive for the expressive benefits of status and the pride that it brings is evident in the life of Stephen Schwarzman. Schwarzman’s father ran a drygoods store providing ample income. When Schwartzman was fifteen, he approached his father with a plan to expand into a national chain, or at least open one more store. “I’m very happy with my life as it is,” his father explained. “I’ve got enough money to send you and your brothers to college. We’ve got a nice house and two cars. I don’t want any more in life.” His mother said “That’s your father. He’s happy!” “I wanted a much bigger stage,” said Schwarzman to Stewart. “I didn’t know what it was, but I knew something had to be out there.”
The social status of deserving rich, such as Bill Gates, exceeds that of undeserving rich with equal wealth, a fact that distresses people in finance who perceive themselves as no less deserving than the Bill Gateses of the world. They resent the ‘fat cat’ label pinned on them by Obama. “America’s super-rich feel aggrieved in part because they believe themselves to be fundamentally different from a leisured, hereditary gentry,” wrote Freeland (2012). She described Leon Cooperman, the founder of Omega Advisors hedge fund, who felt compelled to enter the political debate when he saw President Obama on television urging America’s “millionaires and billionaires” to pay their fair share. Cooperman said that he would be willing to accept higher taxes, “if treated with respect.”

Cooperman, the son of a plumber, attributes his success to talent, hard work and luck. In that, noted Freeland, Cooperman differs from many of his fellow super-rich. “He understands that he isn’t just smart and hardworking but that he has also been lucky.”

**Incentives in the lives of the rich and the poor**

Utilitarian incentives are central in the standard economics and finance framework, where utilitarian benefits are paramount and expressive and emotional benefits are largely absent. People in this framework balance leisure against work. An increase in tax rates provides a utilitarian incentive to reduce hours of work and increase hours of leisure, as the relative price of leisure declines.

This description of tradeoffs between work and leisure is consistent with the behavior of Stephen Schwarzman’s father who declined his son’s prodding to expand his business. But this description is not consistent with the behavior of Stephen Schwarzman who is seeking the expressive and emotional benefits of “a much bigger stage.”
The standard argument against increasing tax rates on the rich is that higher taxes would lead them to reduce their hours of work, such as by foregoing opportunities to expand their businesses. As a consequence, ‘job creators’ would create fewer jobs, depriving the unemployed. Yet facts suggest otherwise. Hungerford (2012) of the non-partisan Congressional Research Service found that “The reduction in the top tax rates appears to be uncorrelated with saving, investment and productivity growth. The top tax rates appear to have little or no relation to the size of the economic pie. However, the top tax rate reductions appear to be associated with the increasing concentration of income at the top of the income distribution.”

The Congressional Research Service has withdrawn Hungerford’s report when Senate Republicans raised concerns about its findings and wording. Still, the report’s findings accord well with the views of Warren Buffett (2012) who wrote “Suppose that an investor you admire and trust comes to you with an investment idea. “This is a good one,” he says enthusiastically. “I’m in it, and I think you should be, too.”

Would your reply possibly be this? “Well, it all depends on what my tax rate will be on the gain you’re saying we’re going to make. If the taxes are too high, I would rather leave the money in my savings account, earning a quarter of 1 percent.” Only in Grover Norquist’s imagination does such a response exist…

So let’s forget about the rich and ultrarich going on strike and stuffing their ample funds under their mattresses if — gasp — capital gains rates and ordinary income rates are increased. The ultrarich, including me, will forever pursue investment opportunities.”
Viewed within the standard economics and finance framework where utilitarian benefits are paramount it seems odd that people such as Schwarzman and Cooperman object so vociferously to paying a 35 percent ordinary income tax rate on their ‘carried interest’ instead of the 15 percent rate on capital gains. After all, Schwartzman, Cooperman, and their colleagues have already accumulated greater wealth than they, their children, and their grandchildren can reasonably consume. Why, then, did Schwarzman describe raising the tax on carried interest as the equivalent of the Nazis invading Poland. The answer is not in higher taxes as disincentives to work. Instead, it is in the expressive and emotional benefits of wealth. Schwarzman is not likely to consume less expensive food if his wealth were to decline from $10 billion to $8 billion. He is not even likely to buy one fewer house. But his status would decline when he finds himself lagging behind those whose wealth exceeds $8 billion. Schwarzman has recently been prodded to donate $100 million to the New York Public Library, sacrificing the utilitarian benefits of that money for the expressive and emotional benefits of his name carved in stone at the entrance to the library.

**Deserving poor and undeserving ones**

At its extreme, the typical American belief that the poor could become rich if only they tried hard enough implies that no poor is a deserving poor. A more nuanced view accepts that some poor are deserving, worthy of a social safety net, distinguishing them from the undeserving poor, unworthy of a safety net. Deserving poor are those who work hard and yet remain poor, whereas undeserving poor are those who fail to work even though they are able to do so, perhaps because they are lazy, or perhaps because the
government coddles them, subsidizing their leisure. The writer of the letter to the Wall Street Journal quoted earlier, distinguished deserving poor from undeserving ones. “The Republicans would never drop the safety net for those in need. The Democrats want to shove more people into it.”

Utilitarian incentives are central in the standard economics and finance framework of the behavior of the poor as in the behavior of the rich. Mulligan (2012) argued that a generous social safety net reduces the relative price of leisure, offering the unemployed incentives to remain unemployed, and offering the poor incentive to remain dependent on government benefits. He wrote: “Unemployment insurance and other types of social insurance subsidize job separations and thereby result in too many layoffs and too few people employed”

There are indeed examples, many heartbreaking, of safety nets offering incentives that perpetuate poverty. Kristof (2012) wrote about parents who profit from their children’s illiteracy, withdrawing them from school because literate children are less likely to qualify for government support for having an intellectual disability. “This is painful for a liberal to admit,” wrote Kristof, “but conservatives have a point when they suggest that America’s safety net can sometimes entangle people in a soul-crushing dependency. Our poverty programs do rescue many people, but other times they backfire.”

The Community Reinvestment Act (CRA) is one program that backfired, at least for some poor. The CRA, enacted in 1977, encourages commercial banks and savings associations to lend to all in their communities, including people with low and moderate
income. Agarwal et al. (2012) noted the heated debate about the role of the CRA in lowering lending standards. Rajan (2010) argued that the CRA, enacted by “a US Congress, worried about growing income inequality, towards expanding low income housing…[helped] remove any discipline on home loans,” whereas Krugman (2010) argued that “the Community Reinvestment Act of 1977 was irrelevant to the subprime boom.” Agarwal et al. found that the CRA indeed led to risky lending, some leading to home foreclosures. They wrote that “adherence to the act led to riskier lending by banks: in the six quarters surrounding the CRA exams lending is elevated on average by about 5 percent every quarter and loans in these quarters default by about 15 percent more often.”

Yet poverty persists, even among the hard-working, for reasons beyond backfiring government programs. Sometimes poverty persists because workers’ fairness right of equal bargaining power is trumped by employers’ fairness right to freedom from coercion. Porter (2012) wrote about José Carrillo and Joshua Williams who work in the fast-food industry, earning little more than $7 an hour and needing food stamps to survive. In early December 2012 they and fellow fast food workers claimed their fairness right to equal bargaining power by going on strike.

Unions promote the fairness right of workers to equal power. Porter noted that In the 1990s and 2000s, the S.E.I.U. unionized tens of thousands of janitors by putting pressure on the building owners. “In 1990, the union asked members to mail their trash to Judd Malkin, the chairman of the company that owned buildings in the Century City complex in Los Angeles, printing his address on garbage bags.” Mr. Malkin met the
janitors’ representatives soon thereafter. Next, S.E.I.U. expanded their campaign for equal bargaining power, framing it as “Justice for Janitors” campaign.

Davidson (2012) illustrated the conflict between employers’ fairness right to freedom from coercion as they offer workers low wages, and the right of workers to equal bargaining power as they ask for higher wages. Davidson wrote that Eric Isbister, the C.E.O. of GenMet, a metal-fabricating manufacturer told him that he would hire as many skilled workers as show up at his door. “Last year, he received 1,051 applications and found only 25 people who were qualified. He hired all of them, but soon had to fire 15. Part of Isbister’s pickiness, he says, comes from an avoidance of workers with experience in a “union-type job.” Isbister pays employees a starting wage of $10 an hour. “From what I understand,” wrote Davidson, “a new shift manager at a nearby McDonald’s can earn around $14 an hour.”

Charitable organizations, such as churches and food pantries, might be better at separating the deserving poor from the undeserving than the government because, unlike government, charitable organizations observe the poor closely. This is why some prefer to weave the safety net with charity instead than taxes. Yet employers can help the poor more than charitable organizations or the government. As Cappelli (2011) noted, employers claim that they cannot find skilled workers, blaming schools that fail to give students the right training, or the government that does not let in enough high-skill immigrant. Yet blame might well rest with employers. Employers “need to drop the idea of finding perfect candidates,” wrote Cappelli, “and look for candidates who could do the job with a bit of training and practice.” Cappelli’s prescription corresponds to the top rung of Maimonides
charity ladder, described by Tamari (1995) as “breaking the poverty cycle and enabling the poor to establish themselves as independent and productive members of society.” The very bottom rung of the ladder is the place of “one who gives unwillingly.” This bottom rung is still higher than the place of those who pay their taxes, not a penny more, after exhausting all methods of avoiding them, including tax deductions for contributions to charity. It is no wonder that one reader of DeSantis’ resignation letter wrote: “That's really nice of you to donate OUR tax dollars to the charity of YOUR choice.”

Philanthropists tend to prefer charity to taxes because charity gives them the power to choose their beneficiaries and be thanked for their contributions. This is why charity where the recipient is anonymous to the benefactor and the benefactor is anonymous to the recipient and the recipient is at the second rung from the top in Maimonides charity ladder.

Still, charitable contributions are insufficient to alleviate poverty as donations to human services charities that ease poverty and feed the hungry amount to less than 12 percent of total charitable contributions. In “A failure of philanthropy” Reich (2005) wrote that “philanthropy does such a poor job of channeling money to the needy that it would not be difficult for government to do better.”

The 2012 electoral losses have prompted some Republicans to reconsider the role of government in alleviating poverty. Paul Ryan, the former Republican vice presidential candidate said “The real debate is how best we can meet [the obligations to combat poverty.] It’s whether they are better met by private groups or by government — by voluntary action or by government action. The truth is, there has to be a balance.
Government must act for the common good, while leaving private groups free to do the work that only they can do.”

Utilitarian incentives do change behavior. Poor families receiving Supplemental Security Income (SSI) benefits for keeping their children illiterate are likely to keep them illiterate, perpetuating poverty. SSI rules that give women raising children more money if they refrain from marrying discourage marriage and perpetuate poverty. Earned-income credit, adding to the income of the working poor encourages work and the likelihood of escaping poverty. But utilitarian incentives alone cannot uplift the poor who have made poor decisions, such as dropping out of school or having children while teenagers, and failed to develop useful habits, such as arriving to work on time and managing the frustrations that accompany any job. Expressive and emotional incentives can complement utilitarian incentives in changing the behavior of the poor and increasing their likelihood of escaping poverty. David Brooks (2012) wrote: “It’s foolhardy to try to persuade people to see the profound errors of their ways in the hope that mental change will lead to behavioral change. Instead, try to change superficial behavior first and hope that, if they act differently, they’ll eventually think differently. Lure people toward success with the promise of admiration instead of trying to punish failure with criticism. Positive rewards are more powerful.”

Conclusion

“America faces a new culture war,” wrote Arthur C. Brooks (2010), president of the American Enterprise Institute. We must choose, wrote Brooks, between a vision where America continues to be organized around the principles of free enterprise and a vision
where America will move toward European-style statism. Brooks exaggerates the
difference between the American system and the European one. In truth, both systems
combine free enterprise with statism, even if the American system is closer to the free-
enterprise end and the European is closer to the statism end. Both systems also offer social
safety nets, even if the American one is relatively thin and the European relatively robust.
The question we face is whether to make the American social safety net thinner than it is or
more robust. Following the elections Douthat (2012) wrote “Liberals look at the Obama
majority and see a coalition bound together by enlightened values — reason rather than
superstition, tolerance rather than bigotry, equality rather than hierarchy. But it’s just as
easy to see a coalition created by social disintegration and unified by economic fear.”
Indeed. Economic fear pervades now, associated, as Stephen Schwarzman said, “with a
society undergoing rapid change. Globalization. Job dislocation. Middle-class anxiety.”
This is a society where people clamor for a more robust social safety net.

a robust social safety net along the lines of many Western European countries, we will
eventually need taxes on the middle class similar to what you see in many of those
countries. If that tax burden is deemed unacceptable, then the American people will have to
rethink the social safety net.”
A Chance to Tackle Inequality

By EDUARDO PORTER

Published: November 20, 2012


Rasmussen: Tea Party Shows Weakness of GOP Establishment Sunday, 19 Sep 2010

By Dan Weil

http://www.nytimes.com/2012/11/18/opinion/sunday/douthat-The-Liberal-Gloat.html?_r=0

The Democratic edge among Hispanics depends heavily on these darker trends: the weaker that families and communities are, the more necessary government support inevitably seems.

Likewise with the growing number of unmarried Americans, especially unmarried women. Yes, social issues like abortion help explain why these voters lean Democratic. But the more important explanation is that single life is generally more insecure and chaotic than
married life, and single life with children — which is now commonplace for women under 30 — is almost impossible to navigate without the support the welfare state provides.

Or consider the secular vote, which has been growing swiftly and tilts heavily toward Democrats. The liberal image of a non-churchgoing American is probably the “spiritual but not religious” seeker, or the bright young atheist reading Richard Dawkins. But the typical unchurched American is just as often an underemployed working-class man, whose secularism is less an intellectual choice than a symptom of his disconnection from community in general.

What unites all of these stories is the growing failure of America’s local associations — civic, familial, religious — to foster stability, encourage solidarity and make mobility possible.

This is a crisis that the Republican Party often badly misunderstands, casting Democratic-leaning voters as lazy moochers or spoiled children seeking “gifts” (as a certain former Republican presidential nominee would have it) rather than recognizing the reality of their economic struggles.

http://www.time.com/time/printout/0,8816,2104309,00.html
