Inside This Issue:

The Tragedy of Proposition J: A Policy Parable
Larry A. Rosenthal

Are Corporate Tax Shelters Unpatriotic?
Denise Shepherd

Laci and Conner’s Law:
The Polarized Debate Over Reproductive Rights
Kimberly Curry and Natalia Barolin

The Dark Side of HOPE:
Crowding Out Need-Based Financial Aid?
Diana S. Lane

Subsidy and Sensibility:
Political Threats to Arts Funding
Jacqueline Beaumont

Nice Work If You Can Get It
Robert B. Reich

Market Failure in the Knowledge Economy:
A Response to Robert Reich
David Deming
Contents

The Tragedy of Proposition J: A Policy Parable
Larry A. Rosenthal ................................. 4

Responses
John Quigley ................................. 9
Helen Oliver ................................. 9

Features
Are Corporate Tax Shelters Unpatriotic?
Denise Shepherd ................................. 10

Laci and Conner’s Law:
The Polarized Debate over Reproductive Rights
Kimberly Curry and Natalia Barolin .............. 14

The Dark Side of HOPE:
Crowding Out Need-Based Financial Aid?
Diana S. Lane ................................. 17

Subsidy and Sensibility:
Political Threats to Arts Funding
Jacqueline Beaumont ................................. 21

Commentary
Nice Work If You Can Get It
Robert B. Reich ................................. 25

Market Failure in the Knowledge Economy:
A Response to Robert B. Reich
David Deming ................................. 27
WELCOME to the second issue of PolicyMatters. We’ve worked hard on this and we hope that you enjoy the result. We’d like to extend particular thanks to Arielle Cohen and Lauren McMahon for their hard work on the editorial side and Karin Martin for her efforts in design and typesetting. We’re delighted that Karin, Simone Berkowitz, Ben Lum and Trisha McMahon have thrown themselves into the PolicyMatters project: it looks like we are on our way to third and fourth issues. As before, we have included a selection of comments from the editorial team. They’re first passes and are intended to spark debate: they don’t represent the considered collective opinion of the PolicyMatters team.

With a presidential election just around the corner, political issues have additional resonance. In PolicyMatters’ inaugural issue, David Kirp explored the role of policy analysis in a world increasingly dominated by politics. Three of our articles this time around testify to this reality. Larry A. Rosenthal’s dissection of the collapse of San Francisco’s latest attempt at an affordable housing initiative (“The Tragedy of Proposition J”) should strike fear into the hearts of sensible policy analysts focused on sensible reform: to paraphrase, right policy, right person, wrong place, wrong time. Kimberly Curry and Natalia Barolin examine the political storm that blew up around the Unborn Victims of Violence Act and conclude that policy analysis had little, if anything, to do with the progress of the debate. Jacqueline Beaumont’s argument about how to fund arts in the United States comes from the other angle but arrives at the same result: policy analysis really shouldn’t have anything to do with arts funding.

We are delighted that Visiting Professor Robert Reich was able to contribute to this issue. “Nice work if you can get it,” relates the political hot potato of outsourcing to its root cause – America’s transition to a “knowledge economy.” Looking through a microeconomic lens, David Deming then examines the consequences of this transition, and makes a case for further government investment in public higher education. By analyzing the impact of the HOPE scholarship program on need-based financial aid, Diana S. Lane looks at the supply side of the knowledge economy and the equity issues involved in training the workforce of tomorrow. Finally, Denise Shepherd presents an ethical perspective on the exploitation of tax loopholes – rarely seen in policy school – and in explaining U.S. laws regarding offshore tax, provides us with another piece of the globalization jigsaw.

Building this issue over six months and three continents has been a real challenge. We think it has been worth it: we hope you do, too.

Richard Halkett & David Deming
October 11th, 2004
IN SAN FRANCISCO, ballot initiatives promising to ease the City’s renowned housing crunch come and go. Housing bonds pass and fail in the City by the Bay, subsidy programs ebb and flow, and the “affordability crisis” as a catchphrase pervades the political agenda in one form or another, and has continuously since World War II.

But few ballot measures in San Francisco have ever suffered so catastrophic a defeat as Proposition J in March 2004, the ill-fated “Workforce Housing Initiative.”

Prop. J was unceremoniously dispatched by a unified electorate, voting a lopsided seventy percent against. Despite the efforts of its mainstream supporters — the City’s popular mayor Gavin Newsom, Senator Dianne Feinstein, the Rev. Cecil Williams of Glide Memorial Church, both major daily newspapers, prominent municipal and business labor unions and trade associations, and the proposal’s main sponsor, the San Francisco Chamber of Commerce – Prop. J cratered spectacularly, joining the ranks of the most embarrassing referendum defeats in the City’s history. For the Chamber’s Roberta Achtenberg — an experienced San Francisco politician and Prop. J’s foremost proponent — the outcome was particularly dismal.

A ballot measure failing to garner thirty percent of the vote is the urban-political equivalent of D.O.A. On its face, Prop. J credibly promised, without a penny of new taxes or public borrowing, to ease regulatory barriers impeding new construction. It would have gradually increased housing supply and densities in only certain neighborhoods – the depressed areas of downtown and the now-vacant parcels of the formerly bustling Central Waterfront district where new stock is sorely needed and surely can be accommodated. Required environmental impact reviews would have been consolidated and expedited. Slight height and bulk bonuses would have rewarded developers willing to risk building mixed-income projects. Approximately 10,000 new units, 39% of which would have been set aside for moderate-income San Francisco workers, would have been added to the stock. For the most worthy projects, fast-track approvals would have replaced protracted tie-ups at the Planning Department. Prop. J was no cure-all, to be sure, but rather a nuanced, incremental set of tax-free policy steps entitled to legitimate chances at implementation and success. Its defeat derailed a genuine opportunity for constructive policy change.

What’s more, Prop. J was proposed on the heels of statewide Proposition 46, a popular $2.1 billion California housing bond, which passed by a comfortable margin in November 2002. Prop. 46 seemed at long last to have heralded the arrival of housing affordability as a mainstay on the California political scene. Its bond proceeds are leveraging millions more in housing construction funds from a variety of public and private sources. Ultimately, however, the exciting momentum the state bond’s success seemed to lend local housing efforts foundered on the shoals of San Francisco politics. The last thing state housing leaders needed in Prop. 46’s wake was a high-profile political disaster like Prop. J.

To their credit, the referendum’s opponents successfully assembled a powerful coalition of owners, landlords, tenants, neighborhood groups, housing activists and homeless advocates. Uniting landlords and tenants on housing policy is no mean feat, and the resulting voting block against the measure proved insuperable. The “No on Prop J” forces managed to depict its authors as architects of the affordability “problem,” writ large, not the designers of a creative solution likely to benefit the working poor. In the Adobe-Photoshop world of politics in the City, the measure’s sponsors morphed from purveyors of incremental policy change into scheming construction barons and their unscrupulous proxies, exploiting the downtrodden at every turn for profit. And most disturbingly, a real chance at constructive policy change may have been commandeered in a cynical play for political payback after a hard-fought mayoral race four months earlier.

The story of Prop. J’s demise is a cautionary tale mired in the complex and divisive politics in San Francisco. Many of the same anti-J voices had tarred candidate Newsom as a conservative patsy well to the right of Arnold Schwarzenegger, just weeks before Mayor Newsom was to secure permanent progressive-hero status around the world for his stand on gay marriage. Perhaps little can be learned when good policy collapses in the cranky crucible that is San Francisco. Yet despite its parochial particulars, the conundrum of Prop. J illumines the quandary faced by any policy innovation in urban housing: persuading owners, tenants and the dispossessed that they all have something significant to gain.
AS SURE AS New Yorkers lament the sweltering summer and envy each others’ weekend getaways to the Hamptons and Fire Island, San Franciscans bemoan the exorbitant cost of housing.

All residents of the City by the Bay have their story to tell. First-time homebuyers contemplate lottery tickets as a rational means to afford a downpayment. Stockbrokers ponder whether six-figure salaries really do disqualify them from receiving government housing subsidies. Commuting from distant suburbs in San Joaquin Valley, San Francisco fire captains and police lieutenants roll to a halt in traffic outside Livermore at 5:00 a.m., praying the City’s victims-in-waiting will postpone their calamities until after rush hour.

As unharmed spectators, San Francisco’s longest-standing tenants rhapsodize about their Reagan-era rent levels, permanently capped by the nation’s most vigilant rent control regime. Meantime the most elderly among them keep the rent board busy staving off all manner of eviction threats, since landlords stand to quadruple their investments by selling their buildings. These section 8 residents see the writing on the wall – if they owned their buildings in this market, they’d sell too. The landlord’s contract with federal regulators to continue foregoing substantial profit in favor of housing the lowest-income retirees provides precious little security for elder renters.

According to a September 2004 report by the California Association of Realtors, just 11% of the City’s households can afford to purchase the region’s median-priced home (as of July 2004, the tidy sum of $660,000). The National Low-Income Housing Coalition’s most recent “Out of Reach” report lists the least affordable counties nationally, and San Francisco, Oakland, San Jose and their suburbs speak for seven of the top ten slots. Fewer and fewer families can afford to buy in the City, but those who manage to become homeowners invariably hit the jackpot. From the standpoint of real estate capital, San Francisco merely lives out its legacy: the gold ran out long ago, but the gold rush never really ended.

The causes of the City’s housing squeeze both perplex and dismay. Demand remains extraordinarily robust despite natural (and worsening) transit bottlenecks on the peninsula and the region’s rather languid emergence from the recent recession. Job growth remains flat in the Bay Area, but among the employed, incomes are outpacing growth trends seen nationally and statewide. Even in this stunted economy (by late-90’s standards), prospective renters and buyers can bid up housing prices, well beyond the reach of the City’s least well-off families. San Francisco’s healthy vacancy rates since the Internet bust have not brought commensurate price relief.

Household formation patterns are dominated by young, wealthy, mobile workers. The City’s population continues to grow – almost 17% since the 1980 census – and has now exceeded post-war levels after a substantial dip. But the housing stock remains stagnant. Overcrowding is an increasing public health concern in the City’s poorest, most ethnically concentrated neighborhoods. On top of these problems, San Francisco continues to be plagued by its national reputation as homeless capital of the West, and the City’s own data bears out the grim reality. A 2002 count found more than one percent of the City’s population living on the streets, in shelters, in treatment facilities, and in transitional housing.

Far from targeting all these problematic conditions at once, Prop. J sought to ameliorate supply constraints at the margin, by adding moderately priced for-sale units in neighborhoods rich with infill-construction opportunities. The measure would have brought mixed-income developers into needy neighborhoods.

Econ 101: structural market-shortages warrant reasonable government action inducing firms to boost production. The notion represents such a fundamental policy stricture that it would appear to render debate pointless. But basic logic has never been much of a constraint in San Francisco.

ALL FACTIONS ON the City’s famously fractious political scene agree, if only facilely, that new housing supply is desperately needed. The conditions for shortage are rampant: more than a generation of rent control; great seismic risk; scarce construction insurance, sophisticated claims institutions and related transaction costs in construction; highly unionized construction labor markets; the City’s moratorium on new
“live-work” loft units; a vibrant environmental movement brandishing the spoils of grand legislative triumphs to oppose all new development in whatever form; and a sluggish recovery from the dot-com bust and recession. Understandably, new housing construction in the City has slowed to a trickle.

But for San Francisco’s incumbent owners and landlords, constricted supply turns out to be great for business. Unaffordability in these precincts is a boon, not a crisis. Housing capital tends to oppose policies aimed at easing prices. With the City’s natural vacancy rate capped at tolerable levels by the mere fact that it is, after all, San Francisco, local owner-occupiers and suppliers of rentals enjoy the advantages of relatively price-inelastic demand. The surge in home prices and rents has made residential real estate investment in the City more lucrative than ever. Nothing matches the glee of a first-time purchaser enjoying a windfall spike in regional home prices after escrow closes. To this sizeable constituency, “workforce housing” is a ready buzzword for “equity depreciation” and “lost revenue.”

Even more unlikely as leaders in the coalition against the initiative, tenants’ rights organizations and homeless advocates distributed a series of devastating anti-J pamphlets in key neighborhoods. In the waning weeks of the campaign, these materials and a well-crafted website and media effort upended what scant hope remained for the measure’s passage. The proposition’s well-intentioned supporters were simply outslugged by better organized forces. The conquerors of Prop. J seemed intent on retaining control of the city’s housing agenda for its own sake; their tactics revealed a frustrating lack of seriously considered policy alternatives with which to bolster their positions. It was as if maintaining their high perch in city politics were a far greater priority than engaging in any principled debate about practicable solutions to the City’s pesky supply problem.

Despite being among the initiative-sponsors’ intended beneficiaries, housing progressives in the City all acted to protect the status quo from the slightest hint of new profit sources for participating developers. They demonized the very builders that civic leaders were trying to entice into the City with measured incentives. Rather than applauding the incrementalism embodied in Prop. J itself, advocates for the poor decried the region’s high home prices and rents, deluding themselves and their constituencies into believing that markets respond more readily to activist harangues than sound policy interventions.

Platitudes of urban desperation ultimately carried the day. A good example: “No on Prop J” estimated that the minimum necessary household income for workforce families to purchase homes developed under the measure would be $87,500 for couples and $109,800 for families of four. Even with only a cursory understanding of Bay Area real estate markets, the opponents no doubt could count the hundreds of additional moderate-income workers in the City who thereby might be able to finally attain the promised land of homeownership.

But to housing progressives as well as homeless advocates, this logic could not compete with the rapid pronouncement that the poor and homeless would, even after Prop. J, only remain poor and homeless. The corollary benefits of expanded aggregate supply, so familiar to market analysts, appeared completely lost on this constituency and its representatives. “Affordable Housing For The People” went the screed, without any accompanying notion of how to get that housing built and paid for. Within the left-skewed political domain of San Francisco, a no-tax, intellectually founded and carefully balanced regulatory-reform proposal like Prop. J failed to attract progressives precisely because it did not redistribute real-estate wealth drastically enough. That a reasoned approach toward relieving housing unaffordability can still be shanghaied, in 2004, by an urban electorate bent on total revolution is actually somewhat quaint.

Meanwhile, planning technocrats and neighborhood preservationists muttered their typical obloquies against “ballot box planning,” choosing pieties of process over urgent action on the paucity of new units. Others belittled the supposed end-run pulled by Prop. J’s sponsors, as if the pure democracy of a plebiscite were necessarily inferior to interminable “visioning” sessions and the cacophony of consensus decision-making. But these cavils stuck.

In the face of this overwhelming coalition – all seemingly agreeing that new workforce housing is not that
desperately needed after all. Prop. J was doomed almost from its inception.

FOR ROBERTA ACHTENBERG, fighting the good fight for her brainchild Prop. J unfortunately became the nadir of an otherwise sterling political career.

As a prominent gay member of the San Francisco Board of Supervisors in 1993, Achtenberg was just the kind of lightning-rod undersecretary candidate President Bill Clinton dreamed of in his quest to craft a squadron of political appointees which “looks like America.” During more than fifteen years as one of the City’s leading civil rights attorneys prior to her entry into local politics, Achtenberg had ascended to serve as a teaching fellow at Stanford University Law School and eventually as dean of San Francisco’s progressive New College of California School of Law.

When Clinton nominated Achtenberg as assistant secretary of Housing and Urban Development in charge of fair housing, she immediately drew fire. In an emotional debate on the Senate floor, Jesse Helms of North Carolina boomed, “I’m not going to put a lesbian in a position like that.” To which Edward Kennedy of Massachusetts thundered in reply, “Bigotry should not disqualify her.”

Achtenberg survived as the pawn in that fleeting, wholly symbolic national debate over homosexual leadership in Washington. She served admirably as assistant secretary and then as senior advisor to HUD Secretary Henry Cisneros. On her return to San Francisco after President Clinton’s first term, Achtenberg brought a newfound appreciation of the key role localities must play in an era when socialized housing for the poor is a political impossibility and federal subsidies for vouchers and new construction alike are vastly insufficient, and shrinking. In 1997 she settled into a cozy office high above the Financial District as the San Francisco Chamber of Commerce’s new senior vice president for public policy.

In Prop. J Achtenberg seemed to have found an ideal cause for her and the Chamber to back: a win-win proposition for the working poor and the construction industry alike. Best-practice research she commissioned for the Chamber had indicated that San Francisco lagged far behind more progressive places like Austin, Texas and Boulder, Colorado in using local regulators to encourage affordable residential development and to finesse barrier ordinances and neighborhood resistance. Even in her private role as a high-profile lobbyist at the Chamber, Achtenberg fancied opportunities to turn government into a progressive tool while fostering the attractiveness of the local business environment. The City could become a model for urban leadership on such reforms, Achtenberg hoped, and she assumed that the cause of new housing construction for the working poor, unfairly stuck in tenancy without any real chance at homeownership, would be a slam-dunk winner across neighborhoods and interest groups.

The gadgetry of relabeling was a key insight. Achtenberg and others have concluded that “affordable housing” has become anathema to entrenched interests in both cities and suburbs. The once-innocuous term is now freighted, even for some moderates, with images of unwanted poor and minorities, slovenly garden apartment complexes, and unwelcome facilities for the elderly, mentally ill, and even families living with AIDS/ARC conditions. Mentions of affordable housing at city council hearings had become sure to douse policy innovation and return all constituencies to their familiar, hardened positions on a dead-end subject.

The new coinage, “workforce housing,” would lend fresh flavor and focus to the specific needs of the police, firefighters, nurses, teachers, and service industry workers for whom homeownership in the City had become an outright fantasy. For the voluble Achtenberg, the new name was just the kind of rhetoric she felt comfortable with, as she navigated the lunch and dinner circuits now customary for a referendum’s sponsoring den mother. Housing the City’s own workers seemed a matter of civic pride around which a broad swath of voters and community groups could rally. The innovative label alone was sure to breathe new political life into a crucial issue which lately had become tiresome and marginalized. Or so Prop. J’s sponsors mistakenly thought.

Achtenberg and the Chamber managed to build a formidable network of support around the initiative’s natural supporters. Aside from Mayor Newsom himself, who appeared willing to make workforce housing and Prop. J the centerpiece of his new administration’s early platform on housing generally, they won endorsements from major newspaper editorial boards, unions, and various neighborhood groups. Gay leaders in the Alice B. Toklas
Democratic Club signed on, as did Senator Dianne Feinstein, peninsula congressman Tom Lantos, Glide Memorial Church’s Rev. Cecil Williams, and a diverse assortment of ethnic community groups and political leaders. They trumpeted the policy wisdom of Prop. J far and wide, only to be steamrolled by the powerful majority aligned against any such experiment.

The last thing Roberta Achtenberg expected was that her formal reentry into San Francisco politics would be hijacked successfully by a disgruntled former candidate for mayor. Just three months prior, Supervisor Matt Gonzalez had amassed a considerable following among the City’s progressives. Gonzalez, a Stanford law graduate and experienced public defender prior to his 2000 election to the Board, had very nearly prevailed as a surprise runoff alternative to the Democratic establishment’s anointment of Gavin Newsom (losing by a 53%-47% margin). Like the underworld, urban politics has its own holy ethic entitling losers to due consolation, and Gonzalez resolved to make Prop. J a tasty dose of comeuppance he would deliver personally to the new mayor.

For the March primary election, by which time the progressive standard-bearing presidential runs of Howard Dean and Dennis Kucinich had long since fizzled, Gonzalez and six of his Board allies reconvened his mayoral campaign forces with as much leftover money and organization as they could muster, to oppose Mayor Newsom on Prop. J. Their troops camped in Gonzalez’s own former headquarters, from which they managed phone banks, a masterful media blitz and an impressive pamphleteering effort.

In essence, the fight against Prop. J rekindled the romance of Gonzalez’s mayoral run. Swing voters who had puzzled over the choice for mayor had considerably less doubt over Prop. J, and they voted in huge numbers to grant Gonzalez the booby-prize he sought. Usually a thoughtful and principled legislator preferring careful policy deliberation to political expediency, Gonzalez used Prop. J to gain a taste of just desserts after the brass ring had narrowly evaded him.

Composing Prop. J’s own eulogy the evening of its resounding defeat, Achtenberg struggled to remain upbeat. “Tonight’s result, while disappointing, is only a temporary setback,” she told the Chronicle. “Starting tomorrow, supporters of Workforce Housing will continue advocating for it until it becomes policy. We build exactly zero units of middle-income housing in San Francisco. That’s a shame, and it must change.” Achtenberg donned the garb of undeterred gladiator, but someone of her experience and savvy had to know that a seventy-to-thirty percent defeat betrayed nothing but the gravest of political miscalculations. She may have suffered a crushing blow to her own standing as an opinion leader and to her political capital in the housing fight. Her Monday speech to the Democratic National Convention in Boston in July, extolling John Kerry’s positions on civil rights, won her nary a mention in the Chronicle.

In San Francisco’s continuing wars over boosting housing supply, presumably Achtenberg has retreated to nurse her wounds and ponder her next move. A new $200 million city housing bond measure on the November ’04 ballot may occupy her full-time, and she will remain busy girding herself for future civil rights, social justice and Chamber of Commerce issues.

But the sting of the Prop. J defeat is unlikely to wear off soon. One would not blame Roberta Achtenberg if she were to decide, in retrospect, that “workforce housing” isn’t such a fancy name after all.
Responses to The Tragedy of Proposition J

by John Quigley

Larry Rosenthal’s highly readable recounting of the fate of Proposition J vividly illustrates the major obstacle to improving housing circumstances in California: the web of locally enacted regulation that prohibits the production of housing. Increases in the housing supply would help reduce the pace at which rents and house prices increase. But practically nobody in California wants this to happen. (After all, almost 60% of Californians are homeowners who profit from higher house prices.)

Coastal California is a desirable place to live, and many rapidly expanding industries have already located here. Current homeowners in these growing regions have little incentive to facilitate, or even permit, increased construction to meet market demand. Given the peculiarities of San Francisco’s rent control laws, current renters have no incentive either. So it’s not exactly a surprise that little housing is built in San Francisco and that, consequently, local housing prices are double the prices elsewhere in the state (actually “only” 88% higher in 2000 than the average of the rest of the state).

The politics of land use make it difficult to confront the problem. Given the increases in housing demand, it may very well be in the narrow self interests of existing residents to enforce rules which make it difficult or impossible to increase housing opportunities. But it is hardly in the common interest of the area’s residents to enforce longer commutes on local citizens, to increase congestion on arterial roads, and to make the region less competitive in national and world markets.

Regional interest groups, typically civic leaders and local business executives who are sensitive to the competition for labor and products among regions, seldom have the clout or the moral authority to affect changes in restrictive land use practices. So what’s left?

The only real hope lies in efforts at the state level to remove or reduce local regulation of new construction in California cities. Unfortunately, much of the action at the state level is in the wrong direction. State laws requiring some attention in land use planning to the needs of low income households have no enforcement mechanism. Instead, much attention is devoted to planning fads like “smart growth” rather than to removing obstacles to the market processes which would increase housing supply. These processes work pretty well throughout the U.S. economy, even in most housing markets outside of California.

John Quigley is the Director of Berkeley’s Program on Housing and Urban Policy.

by Helen Oliver

Larry Rosenthal’s narrative of the failure of Proposition J describes a policy wonk’s worst nightmare: a carefully researched, crafted, and vetted policy is stymied at the last minute by an unexpected and arguably uninformed vocal opposition. What is missing from the story, however, is a critical analysis of the electoral dynamics, political coalitions, and power politics that led to this outcome.

Roberta Achtenberg’s glaring mistake was her apparent failure to anticipate the reaction of the progressive coalition and make peace with them before launching her campaign. Sure, hindsight is 20/20 and perhaps the movement was unexpectedly energized by Matt Gonzales’s mayoral campaign, but homeless and tenants’ rights advocates have always been a major force in San Francisco politics. All else equal, “workforce housing” and “no relief for the poor” may both strike chords with San Francisco voters, but the progressives worked harder. Did Achtenberg ignore her opponents, naively thinking her A-list endorsements were enough? Did she try to garner more grassroots support at the beginning only to be rebuffed? Were there any agreements that could have been made but were not? Or perhaps she could have sensed the Gonzales tide and decided to hold the proposition until next year. Rosenthal does not provide answers to these questions, but they are crucial to the future of the San Francisco housing wars.

Helen Oliver is a second year MPP student at the Goldman School of Public Policy.
As Tax Day looms large for millions of Americans, those who skirt their tax obligations and the peddlers who aid and abet this unpatriotic class of tax evaders are forcing honest taxpayers to pick up the slack and shortchanging their home country. It seems some companies don’t have their hearts in America if they aren’t willing to pitch in their fair share and pull together.”

U.S. Senator Chuck Grassley’s remarks represent a trend toward drawing public attention to corporate tax dodgers and the “lost revenue” they represent. But do the politicians have it right? Is corporate tax avoidance, particularly the use of tax shelters, a “disgusting deeply unpatriotic act especially during wartime?”

Tax evasion is not the only charge being levied — the American corporation is under extreme scrutiny from all corners. Because of intense competitive pressures in an increasingly globalized marketplace, corporations must maximize shareholder returns by any means necessary. Social responsibility is the catchphrase of the moment, as stakeholders from community organizations and even retirement funds ask companies to consider how their business practices affect the world around them. And in the wake of the Enron and Worldcom scandals, the Sarbanes-Oxley Act of 2002 prescribes significant individual liability (including possible criminal penalties) to any director or officer not engaging in proper oversight of business processes.

In light of these conflicting pressures, are corporations that use tax shelters unpatriotic? Or are they doing what corporations do: maximizing profits by minimizing legitimate costs? The answer lies somewhere in the middle: while blatant violations of clearly defined tax statutes are wrong, corporations that minimize taxes while engaging in legitimate business transactions act in the best interests of their shareholders and consumers.

Assumption One: All tax shelters are illegal
Simply put, a tax shelter is any investment strategy that enables a taxpayer to decrease or avoid taxation, and there are multiple legal and government-sanctioned tax shelters. For example, a Roth IRA is a tax shelter because investment proceeds are generally protected from taxation. The purchase of a home might also be considered a tax shelter — the U.S. government allows homeowners to deduct their mortgage interest from their tax liability, which provides an incentive to reduce taxes by owning rather than renting.

Why does the U.S. government allow certain tax shelters and not others? The government can influence taxpayer behavior by manipulating taxes. Roth IRAs encourage retirement savings, and mortgage interest deductions promote increased homeownership. These tax shelters and other legally-sanctioned strategies tend to reflect the current values of the U.S. government and the larger society, both in terms of ideology (e.g. the intrinsic value of owning a home) and analysis of long-term economic health (e.g. weighing the long-term benefits of a working population with significant retirement savings against the current cost of the tax shelter).

Assumption Two: Corporations that move their money offshore do so to avoid paying taxes
For domestic corporations, the United States uses a “worldwide” tax system which provides that all of a domestic corporation’s income is subject to U.S. taxation, regardless of whether the income is earned at home or abroad. The tax code further dictates that the income earned by a domestic parent corporation from operations conducted by a foreign subsidiary is not taxed in the United States unless and until the foreign subsidiary distributes the income to the domestic parent corporation as a dividend.

Congress enacted the “Subpart F” anti-deferral provisions to prevent corporations from avoiding taxation by keeping income out of the U.S. These provisions allow the domestic parent corporation to be taxed immediately on the income earned by the foreign subsidiary if it is considered a “controlled foreign corporation” (i.e. the parent owns above a certain threshold percentage of shares in the subsidiary). Income earned solely within the subsidiary’s country of origin is not subject to this taxation.

It should be acknowledged that because of confidentiality provisions in countries like the Cayman Islands, it is possible that corporations may misstate their actual earnings and assets in an effort to avoid the payment of U.S. income taxes, though this is illegal behavior and not a sanctioned practice.

The tangled web of tax shelter law & policy
Two questions logically follow: First, how do you define an abusive, or illegal, tax shelter? Second, what is the extent of the problem in the U.S.? The answers to these questions require examination of a century of jurisprudence, and include a great deal of uncertainty.

Currently, the United States defines illegal tax shelters in several sections of the IRS code. In general, an abusive tax shelter is “any entity, plan, arrangement, or transaction, a significant purpose of the structure of which is the avoidance or evasion of Federal income tax [emphasis added].”¹⁴ The courts have often intervened by interpreting whether specific transactions constitute violations of the tax code. The primary method of assessing whether a transaction amounts to an abusive tax shelter originated in the Supreme Court case of Gregory v. Helvering⁵ and has resulted in a long line of common law decisions on the “economic substance doctrine.” A transaction with economic substance must (1) produce a meaningful change in the taxpayer’s economic position, and (2) have a tax-independent business purpose.⁶ The courts can “…[balance] the transaction’s risk and return potential in order to determine whether the transaction had any purpose beyond reducing or avoiding tax liability.”⁷

However, the outcome of jurisprudence on tax shelters has been mixed, and courts are divided in their decision-making. For instance, in 2001, two strikingly similar cases had markedly different results. Both transactions involved the purchase and sale of American Depository Receipts, one by Compaq Computer Corporation and the other by IES Industries; both companies subsequently claimed a foreign tax credit and a capital loss to the IRS. The Eighth Circuit Court of Appeals held that the IES Industries’ transaction had economic substance,⁸ but the Tax Court found that the Compaq transaction did not have business purpose and was a sham transaction.⁹ These differing outcomes reveal how unpredictable courts can be in defining the parameters of abusive tax shelter behavior. Whether and how to codify the economic substance doctrine in order to more clearly define abusive tax shelters and impose appropriate penalties has been heavily debated by a variety of stakeholders, including Congressional leaders.

Penalizing abusive tax shelter behavior would be particularly important if the scope of the problem put a significant dent in U.S. tax revenue. However, given that there is such uncertainty about what behavior is abusive, it is incredibly difficult to quantify the issue. The U.S. Treasury Department tried to do that, claiming that approximately $10 billion a year¹⁰ is lost to abusive tax shelters. But there is little or no information available about their methodology in arriving at that figure.

Perhaps the IRS has a better understanding of the extent of the problem. Unfortunately, even Internal Revenue Service Commissioner Mark W. Everson acknowledges that “Estimates vary on the size of this problem … it is very difficult to make a precise determination based on the many different interpretations and definitions of abusive tax shelters.”¹¹

Given that the U.S. still has not definitively characterized abusive tax shelters, and has little idea what the impact of the problem is, to what extent are politicians and pundits who single out “unpatriotic corporations” justified?

**Patriotism:**
"Devotion to the welfare of one's country"

Consider a hypothetical corporation that engages in absolutely no behavior that might be considered ‘unpatriotic’ or tax dodging, one that has not hired any tax planning personnel, and uses no external tax planning promoters. As a result, the company is taxed at the maximum rates at the local, state, federal, and foreign levels, and often taxed by multiple levels of government on the same income. Would such a corporation have any profits? At this rate, would it stay in business?

This is an extreme example, but illustrates an important point. Why does the government allow corporations to have tax planning professionals at all? Why not ban all complex corporate structures? Wouldn’t it be easier to spot illegitimate transactions by requiring that all transactions be completely transparent and perfectly simple? To some extent, the government recognizes the right of the corporation to structure its business activities in an advantageous fashion for its consumers, shareholders and employees. Because consumer happiness and investor confidence are primary contributors to a robust economy and the overall welfare of the nation, and because patriotism is fundamentally a
devotion to improving the nation’s welfare, corporations that rationally act to improve the well-being of consumers and investors do not behave unpatriotically. Legitimate business transactions that are structured to minimize the corporate tax burden are rational responses to the pressures corporations face. And in a globally competitive environment, all companies are playing by the same rules.

Tax planning professionals generally view the payment of taxes as a legitimate cost of doing business. Tax departments are increasingly viewed by corporations as profit centers for the corporation, and face pressure to put business deals together in the most cost-effective way. If a company has a choice between several methods of structuring transactions, the firm will choose the option that maximizes its profits. Though discussions of tax shelter behavior often point to the complexity or abnormality of arrangements as evidence of tax sheltering, the unusual or complex transaction should be no less legitimate. Avoiding tax liability is not the same thing as failing to pay owed taxes. Should it be illegal to sell stock on January 1 rather than December 31st to reduce tax liability? That it is customary to sell on December 31st should not matter; the transaction is legitimate, and the choice is a rational decision designed to minimize cost.

Corporations also act rationally when they minimize tax payments in the ordinary course of business. First, greater opportunities exist today for corporations to increase their market competitiveness by using tax shelters. In connection with the movement toward free trade, certain countries make it very attractive for corporations to create tax-advantaged situations. And because both consumers and shareholders demand that companies bring “good deals” to the marketplace, the need for lower product prices and higher stock values drives the American corporation to minimize costs in every way possible.

Second, the IRS code is an ambiguous and complex regulatory framework for corporations to follow, and agency and judicial enforcement of tax shelter statutes has been contradictory. Labeling a corporation a “tax dodge” relies on individual discretion to an incredible extent. For example, in the previously mentioned Compaq and IES cases, IES met the “business purpose” requirement by “[meeting] twice about the transactions and [consulting] outside accountants and securities counsel for reassurance on the legality of the transactions and their tax consequences.” But in the Compaq case, the Tax Court concluded that the expected tax benefits of the transactions were what motivated the company.

In addition, the IRS response to abusive shelters is necessarily reactionary. Current enforcement of tax shelter law is based on the disclosure of a list of tax shelter transactions by corporations, individuals, and promoters of tax shelters that is amended from time to time. But this logic is circular: (1) the IRS audits corporate tax returns, (2) finds and penalizes transactions it believes to be abusive by levying fines, and (3) adds those transactions to the list for disclosure and possible penalties. Corporations that subsequently enter into similar transactions are subject to penalties for blatant violations of the law. There is significant uncertainty surrounding whether a new transaction will be judged abusive, but once that transaction is added to the regulations, corporations would not likely attempt it.

A marked difference exists between engaging in forbidden behavior and acknowledging uncertainty in the tax code to achieve the primary goal of profit maximization. That difference is the main reason that corporations that minimize taxes as a legitimate business cost should not automatically be labeled unpatriotic. Rhetoric about patriotism conveniently ignores that corporations act in the best interests of their consumers, employees and shareholders by minimizing costs, and obfuscates the fact that well-performing American corporations do help to improve the welfare of the nation.

**Rhetoric about corporate patriotism: why should we care?**

Rhetoric alone is simply free speech; rhetoric accompanied by legislation may have negative consequences. In an attempt to better define abusive tax shelters and provide guidance and increased enforcement, Congress has proposed multiple legislative prescriptions, including the codification of the economic substance doctrine. As previously discussed, abusive tax shelters are difficult to define and assess. If Congress is overly broad in its definition, many legitimate business transactions may either be labeled as abusive shelters, or Congressional action could have a “chilling effect” on corporate transactional behavior.

Given the competitive global environment, the increasing scrutiny corporations receive from various stakeholders on their governance practices, and current controversies over
corporate outsourcing and expatriation of capital, is the American corporation the appropriate target for blame about revenue loss? Corporations might hesitate to enter into potentially lucrative transactions for their shareholders, consumers and the U.S. economy. We may also risk the prospect of some corporations balking at doing business in the U.S. altogether.

The government plays a key role in promoting certain types of taxpayer behavior. Just as the Roth IRA constitutes a tax shelter that encourages people to save for retirement, corporations should be allowed to structure legitimate business transactions in the best interests of their consumers and shareholders, who demand low prices and high share values. The economic welfare of the nation, as measured by numerous indicators, is improved with healthy corporate profits and increased corporate transactions. Why alienate corporations by engaging in critical and unfounded rhetoric, backed up by potentially damaging legislation? We should be rethinking our assumptions about what constitutes patriotism.

FROM THE EDITOR:
Ms. Shepherd defends the American corporation’s right to maximize the advantage of tax shelters, claiming that they are just rational actors trying to get the most out of the government’s complex tax structure. What right do we have to question the profit-maximizing behavior, she posits, if we have deemed tax shelters a legitimate transaction? She claims that tax shelters are in fact a reflection of the government’s and larger society’s values. Excuse me, but I believe American corporate tax law is a reflection of the power of the corporation’s purse. Sure, they may be playing by the rules, but they have had undue influence in creating those rules, wending them to fit their desires regardless of the larger social context of their actions. Corporations buy and sell influence, pay minimally for a favorable tax structure, and use our “nation’s welfare” as a tool for improving their own.

Denise Shepherd is a 2nd year student at the Goldman School of Public Policy, and worked on corporate governance matters in her former life. She would like to thank Paul Matsusaka for his invaluable assistance on this article.
Laci and Conner’s Law: The Polarized Debate over Reproductive Rights
by Kimberly Curry and Natalia Barolin

**The Brutal Murder** of Laci Peterson and the loss of her unborn son, Conner, in December 2002 reignited the fierce debate over fetal rights. The response of the public and political community was immediate: the crime committed was something more than the murder of Laci; but how to adequately define, honor, and protect the additional loss complicated policy making. The subsequent support for a federal law that recognized an additional loss (to supplement existing state laws) reinvigorated the moribund campaign for the Unborn Victims of Violence Act (UVVA; first introduced July 1999; now commonly referred to as “Laci and Conner’s Law”). The UVVA was introduced with mixed motivations: one to “honor” the “unborn victims” in attacks on or murders of pregnant women; and two, to open another front on the precarious and closely-guarded abortion rights granted in *Roe v. Wade*. In the context of the George W. Bush administration’s stance on abortion and a woman’s “right to choose,” pro-choice advocates determined a clear and present danger. The response was to vigorously oppose the UVVA and introduce the Lofgren Amendment (or Motherhood Protection Act, MPA). Both sides ostensibly agreed that crimes harming a mother and her unborn child deserved harsher penalties, but both were really fighting for what was unsaid: the legal definition of personhood central to the debate over reproductive rights. The MPA was defeated in the Senate 50-49, clearing the way for the passage of the UVVA 61-38, which President Bush signed into law on April 1, 2004.

There is no question that Americans believe criminals should be prosecuted for a separate offense if they harm or kill a fetus. A *Newsweek* and Princeton Survey Research Associates Poll released on May 31, 2003, found that of the 47% of Americans who are pro-choice, 81% believe that prosecutors should be able to bring a separate murder charge against someone who kills a fetus in the womb (41% support extra prosecution in all cases and 40% only when the fetus is viable). We can reasonably assume that the vast majority of the 48% of Americans who are pro-life also support prosecuting an attack on a fetus as a separate offense.

Responding to such sentiments, the UVVA amends the criminal code and the Uniform Code of Military Justice to create a new, separate offense if, during the commission of certain federal crimes, an individual causes the death of, or bodily injury to, a fetus at “any stage of development.” Reproductive rights activists fought steadfastly against the law arguing that, “It is part of a deceptive anti-choice strategy to make women’s bodies mere vessels by creating legal personhood for the fetus.” The UVVA’s specific exclusion “of any person for conduct relating to an abortion” failed to reassure pro-choice advocates.

Superficially, the bill presents very little threat to reproductive rights. The explicit exceptions in the bill itself prevent the law from applying either to abortion or to the mother’s own behavior. Only if future statutes take the wording “at any stage of development” and use it without defining it could a challenge to abortion arise. Even then, to have any impact on abortion regulation, the phrase would have to be legally interpreted in a manner that would conflict with *Roe v. Wade*. Since many states already have statutes on their books that have been ruled unconstitutional (and therefore unenforceable) because they conflict with *Roe*, the creation of more such statutes does not pose a significant risk. The other danger is that the language will somehow add to the body of “public opinion” evidence that the Supreme Court could presumably use to overturn or modify the *Roe v. Wade* decision itself. However, if recent Supreme Court decisions are any guide, changes to *Roe v. Wade* might have more to do with the future composition of the court than the language of any particular law.

Given that the UVVA does not pose an imminent legal threat to abortion and it seeks to protect women and their unborn from harm, this law should have brought both sides of the abortion debate together. A logical extension of protecting a woman’s “right to choose” would seem to be to protect her ability to “choose” to carry a pregnancy to term and give birth to the child. Yet, pro-choice advocates fought vigorously to oppose this law for two reasons: to prevent future legal maneuverings that would change the definition of “personhood” and to win a political battle that they desperately needed.

Although the UVVA does not directly attack abortion, it does undermine the ruling under which abortion is currently protected. The UVVA represents the first federal law granting separate legal rights to the fetus. Opponents argue that the law’s definition of an “unborn child” as a “child in utero,” meaning a “member of the species homo sapiens, at *any stage of development*, who is carried in the womb” [emphasis added] was another step in the gradual erosion of women’s reproductive rights. The UVVA explicitly applies to all stages of prenatal development, recognizing a zygote (fertilized egg),
a blastocyst (pre-implantation embryo), an embryo (through week eight of pregnancy), and a fetus all as potential victims of violence with distinct legal rights separate from the mother who has been harmed. The Center for Reproductive Rights argued that “the bill is another attempt by anti-choice legislators to advance their theory of ‘fetal personhood’ in a campaign to undermine the right to choose abortion,” as protected by the U.S. Supreme Court’s finding in Roe v. Wade that the word “person” does not include the unborn for purposes of fourteenth amendment protection.3

In order to remedy this perceived threat, opponents of the UVVA proposed the Motherhood Protection Act, as an equivalent substitute. The MPA, like the UVVA, would have attached harsher penalties for attacking a pregnant woman and/or causing an “interruption in her pregnancy.” Generally, the Motherhood Protection Act would have imposed an equivalent if not stiffer penalty on perpetrators but would have focused on the “pregnant woman” rather than the “unborn child.” The MPA outlined additional stringent punishments for “whoever engages in any violent or assaultive conduct against a pregnant woman … and thereby causes an interruption to the normal course of the pregnancy resulting in prenatal injury (including termination of the pregnancy).” For pro-choice advocates, this appeared to be the perfect solution: an equivalent result in terms of providing consequences for the perpetrator and acknowledging a woman’s right to carry a pregnancy to term while avoiding a sticky dispute over setting a precedent of separate fetal rights.

If the issues at stake really were enhanced punishment and general deterrence, surely the two amendments should have been viewed as essentially equivalent from a policy perspective and the opposition to the substitute bill should not have been particularly strong. However, that was not the case.

Some proponents of the UVVA sincerely believe that their law differs from the MPA because it “honors” unborn victims of violence and gives legal recognition to the loss. Sharon Rocha, mother of Laci Peterson, and Shiwona Pace, an attack victim and a UVVA advocate, both support this viewpoint. On the day before her due date, Shiwona Pace was brutally attacked by three men, hired by her former boyfriend who shouted, “Your baby is dying tonight.” Shiwona’s unborn daughter, Heaven Lashay, died in her womb during that attack. Shiwona argues that “it seems to me that any Congressman who votes for the one victim amendment is really saying that nobody died that night, and that is a lie.” Sharon Rocha did not believe that the MPA was an acceptable substitute stating, “I hope that every legislator will clearly understand that adoption of such a single-victim amendment [The Motherhood Protection Act] would be a painful blow to those, like me, who are left alive after a two-victim crime, because Congress would be saying that Conner and other innocent unborn victims like him are not really victims — indeed, that they never really existed at all.” Representative Chabot agrees that “the criminal law does not exist only to punish criminals, it exists to lend dignity to victims, including unborn victims … Ultimately, the criminal law is not a schedule of punishments. It is an expression of society’s values.”4

However, there are advocates for the UVVA with very different motives for supporting the particular language of the legislation. For example, Senator Orrin Hatch made no mystery of his motives when stating, “They say it undermines abortion rights. It does.”5 Even though the UVVA is legally ineffective in eroding reproductive rights, some advocates clearly sought to do just that.

Thus, just when it appears that both sides of the abortion debate can come together on this issue, the dividing line resurfaces. Not because the opposing sides disagree that criminals should be prosecuted and punished for harming a pregnancy or the unborn, but because they disagree on how to define the crime — on how to identify what or who is harmed. The automatic division into pro-life and pro-choice camps seems to be the primary cause of this disagreement. Herein lies the true dilemma: how can we adequately express society’s values in law when this very same society is so divided?

In the current political climate, the pro-choice community faces serious threats to the reproductive rights they dedicate themselves to protecting. The current administration perpetuates these threats through policies including abstinence-only education, the global gag rule, the “partial birth abortion” ban, and withholding $34 million in funds already allocated for the United Nations Family Planning
Laci’s and Conner’s Law - continued

Fund (UNFPA), all against a background of conservative judicial appointments. In this context, the UVVA appeared as yet another strike against reproductive rights. Although the UVVA does not itself affect access to abortion, one could argue that it inherently threatens the mother’s control of her body. The law introduces into statute the concept that once a woman is pregnant, she is no longer one person but two. This implies that society values the rights of the unborn to the same degree as those of the mother. Given American society’s ongoing debate over balancing the value of life against the rights of women, this message is extremely threatening to the pro-choice community. It is conceivable that this type of legislation would not be so controversial if the current political climate surrounding reproductive rights was not polarized. Perhaps the response of pro-choice advocates to the UVVA was a futile use of resources. But given the existing state of politics, the pro-choice community could not allow another blow (however indirect) to women’s reproductive rights, even in order to sufficiently “honor” unborn victims.

1 Roe v. Wade defines viability as the point at which a fetus is “potentially able to live outside the mother’s womb, albeit with artificial aid” and “presumably has the capability of meaningful life outside the mother’s womb.”
5 Ibid.

Kimberly Curry is a 2nd year student at the Goldman School of Public Policy, having both a personal and policy interest in reproductive rights. She previously worked with the RAND Corporation and currently works with the Public Policy Institute of California.

Natalia Barolin is the development associate for Planned Parenthood Golden Gate and a communications consultant for the Association of Reproductive Health Professionals. She is a feminist dedicated to reproductive rights and was drawn to this topic because of the controversy and threat it created despite its effort to protect women’s rights. She’d like to thank Kimberly Curry for inviting her to co-author the article.

FROM THE EDITOR:
Curry and Barolin’s article is an excellent illustration of why MPP students should stay well away from fetal rights policy. Because the subject is so emotive, because Roe v. Wade is so precarious, because of the religious angle, there can never be rational debate and incremental policy improvement. Moreover, in contrast to taking a stand on water-pricing, you’re far more likely to be physically assaulted by either side. The skills of policy analysts are in short supply and, if it is not already, one of the maxims of its practitioners should be “pick battles you can win.” The “indirect attack on reproductive rights” argument is a good one, but we must not lose sight of the overall result: pro-choice campaigners picked a fight and lost. Arguably, they are now worse off than if they not picked the fight at all.

FROM THE EDITOR:
This article alludes to but does not explore the perennially perplexing cognitive dissonance that characterizes pro-life proponents. Why does the righteous passion and fury behind a law like this one seem to evaporate when it comes to funding pre- and post-natal care or national healthcare? In saving the lives of thousands of infants, surely these programs would do more to ‘honor’ the unborn. This lack of consistency could help prompt a vehement reponse from pro-choice advocates, if they feel the true motives of the pro-life supporters are being obsfuscated behind marketable taglines of questionable substance.
**Merit Scholarship Programs** for undergraduate students are changing the landscape of government-sponsored financial aid for college students. Many of these programs are modeled after the Georgia HOPE (Helping Outstanding Pupils Educationally) Scholarship Program, which allows any recent Georgia high school graduate with a GPA of 3.0 or higher to attend the state’s public colleges and universities free of charge. The program also offers a $3,000 subsidy to those eligible students choosing to attend an in-state private university. Notably, the family income of the recipient is not considered when allocating the awards. Consequently, Georgia has become the largest distributor of state-sponsored non-need-based undergraduate aid in the nation. In the 2001/2002 academic year alone, Georgia granted over $327 million in merit-based non-need undergraduate aid. Since the inception of that program in 1993, eleven other states have implemented their own versions of state-sponsored merit aid programs, which are available to students of all income levels.

Merit aid programs like HOPE enjoy strong political support because they ostensibly champion equal opportunity for all students. Furthermore, aggregate state-level financial aid funding often grows following the implementation of these programs, generating excitement among those who would like to see greater public spending on higher education and on financial aid. In all this enthusiasm, however, policymakers and citizens have failed to consider the distributional consequences of these programs.

There is strong evidence that the HOPE scholarship and other similar types of merit aid are helping wealthy white students more than poor or minority students. In its 2002 report *Who Should We Help? The Negative Social Consequences of Merit Scholarships*, the Harvard Civil Rights Project paints a bleak picture of merit aid programs. Specifically, they found unequal distribution of merit aid funding across racial and socioeconomic lines in Georgia, as well as in Michigan and Florida. This is in large part due to the fact that minority and low-income students historically perform lower on the measures (including high school GPA and standardized test scores like SAT or ACT) used to determine eligibility for almost all state-sponsored merit aid programs, and the programs do not offer other ways for students to demonstrate “merit.” Holding all else equal, merit aid programs have been providing a boost to wealthy white students while leaving low-income minority students behind.

Part of this, however, is inherent in the design of merit aid programs. After all, need-based and merit aid further policy purposes that are fundamentally different. Need-based aid is designed to ensure equal access to higher education. Merit aid is designed primarily to create incentives for and reward certain types of behavior (strong academic achievement, athletic prowess, staying in-state for college and halting “brain drain”). The popularity of merit aid programs is rooted in the American ethos that those who work hard and demonstrate success deserve to be rewarded over those who do not – it is only with wishfully crossed fingers that we should expect merit programs to have equal outcomes across all demographic groups. Because the purposes of need-based and merit aid policies are so different, it is important to understand how the introduction of merit aid has affected the provision of need-based aid.

Different policy goals aside, merit aid is unambiguously good so long as it complements rather than replaces need-based aid. In other words, if merit scholarships do not preclude receipt of other types of state and federal aid, no one loses – the “pie” is simply made bigger for everyone. It is the explicit reduction of need-based aid – cutting a smaller slice from the same “pie” – that harms low-income students, not the existence of merit aid alone.

NEW PROGRAMS HAVE a mixed effect on the composition of aggregate funding levels. The available data show that the introduction of a new merit aid program such as HOPE typically causes aggregate state-sponsored grant levels to rise. This growth can indeed be seen as “making the financial aid pie bigger” either because the political resonance of merit aid stimulates increased funding or because it is funded with new revenue sources like lotteries. From 1994 through 2001, the total state-sponsored aid per high school graduate was nearly twice as large in states where HOPE-like merit aid programs were in place than in states where there was no such program. Georgia itself shows one of the largest such effects: aggregate state-sponsored aid per student rose from $116 million in the 1994/1995 academic year to $362 million in 2001/2002, and all but one of the twelve states experienced some aid growth during the same period.

Despite aggregate aid increases, however, need-based aid does suffer following the implementation of HOPE-like programs in some states. Georgia itself is the biggest
culprit; from the 1993 academic year, when the program started, Georgia’s need-based aid funding dropped steadily from an average of roughly $5 million annually to zero in 1999. Data from Louisiana tell a similar story, with need-based aid dropping from a ten-year average of nearly $5.5 million from 1987 through 1997 to less than $1.5 million following the adoption of a non-need-based merit aid program. If the negative effect of state-sponsored merit aid on need-based aid were systematic across many states, it would cast serious doubt as to whether the financial aid pie were really getting bigger for everyone under these programs.

**Analysis of need-based and merit aid – substitutes or complements?**

To determine the effect of HOPE-like programs on state need-based financial aid, I performed regression analysis on state-level financial aid data over an eight-year period. My statistical analysis of the actual state grant-making behavior nationwide shows that, during that period of time, the introduction of a HOPE-like program had a significant negative effect on the growth of need-based aid, shrinking the increases in need-based aid relative to non-need aid to approximately zero. There are many possible explanations for why this substitution of merit- for need-based-aid might occur, but my own theory rests on an assumption about legislative behavior – that when a financial aid source that is theoretically available for all students regardless of income grows rapidly, legislators might believe that low-income students previously served by need-based aid are “covered” by the new program. Their ideals about hard work and education may prevent them from understanding that those who receive the merit aid are really those who need it least.

The net effect, however, is to reduce the growth in need-based aid to close to zero, not to promote large decreases in the total amount being awarded. That is, while merit aid may indeed be making the whole financial aid “pie” bigger, it may be stunting the growth of, but not dramatically reducing, the availability of need-based aid relative to national trends. Specifically, in HOPE-program states, a one thousand dollar increase in per capita non-need aid corresponds to a small decrease in per capita need-based aid of $50. In contrast, in non-HOPE program states, there is a positive correlation between per capita need-based and non-need-based aid, with a $1000 increase in non-need aid corresponding with a $310 increase in per capita need-based aid. Given previous research showing that low-income students already receive little of the HOPE program funding, it appears that the financial aid “pie” is only getting bigger for those who need it least. While per capita need-based aid does not appear to be “crowded out,” its growth is certainly stunted.

However, it is possible that the systematic negative effect on need-based aid is due to selection bias in states that implement merit aid programs. That is, perhaps the states with HOPE-like programs are states that historically treated need-based aid and merit aid as substitutes anyway. In that case, the merit aid programs may represent an expansion of funding to public universities that does not significantly disrupt need-based funding growth patterns.

**Merit aid must be well-targeted to achieve equity goals**

In a way, an expansion in merit aid funding is no different from the funding that subsidizes tuition for wealthy California residents at its flagship universities, UC Berkeley and UCLA. Students gain admission to these universities because of their strong academic record and reap the benefits of the tuition differential between those schools and their private competitors. Thomas Kane elaborates on this dynamic in his book, *The Price of Admission: Rethinking How Americans Pay for College*.

When a person’s eligibility for such public largesse depends solely on the ability to be admitted to college, the subsidies are bound to benefit higher-income youth disproportionately because they are more likely to have the academic preparation in high school to succeed in college.

With income inequality rising and college tuition becoming more expensive, promoting college access may be a more appropriate role for the public sector than rewarding achievement. Particularly at prestigious institutions, admission itself offers the clout that the degree will carry – and along with it a salary premium after graduation. Public institutions add a further financial reward by making tuition cheaper for in-state students.

It is in the area of promoting college access that the
public sector has tremendous room to grow, particularly because private universities and lending institutions do it so poorly. We should be using merit aid resources to:

1) Develop programs that make state schools more attractive to high performing students (rather than buying them off with free tuition); and

2) Fund need-based aid for any low-income student that universities deem worthy of admission. This way, we would promote both access to college and high achievement standards.

Ultimately, merit aid programs like the Georgia HOPE scholarship measure “merit” with a blunt instrument as compared to the admissions criteria of strong public universities, which allow students with lower GPAs or standardized test scores opportunities to demonstrate their merit through essays, recommendations and demonstrated leadership experience. Need-based aid increases access for these lower-performing, low-income students in a way that merit programs cannot, specifically targeting and leveraging the higher price-sensitivity of low-income youth with respect to higher education.10

Although the public policy goals of need-based and merit aid are distinct, they need not be at odds with one another. California combines both ideas by offering a merit aid program that specifically targets low-income students, the CalGrant, which includes an income cap for recipients.11 The CalGrant program successfully focuses scarce financial aid resources on increasing access for low-income students while simultaneously creating incentives for those students to work hard in high school.

Not only do income capless merit aid programs disproportionately benefit those student that need the financial aid help the least, but this analysis demonstrates that need-based aid may also lose out to merit aid programs as state resources dwindle. States must ensure that, for those students who do not qualify for merit aid like the HOPE scholarship but still warrant admission on other grounds, there will be need-based aid to make sure that college remains affordable.

Diana S. Lane is a Masters student at the Goldman School of Public Policy, and she expects to complete her MPP in May 2005. She looks forward to working on welfare and education policy issues following graduation. This article was based on a research paper she prepared for a public policy class in May 2004; for a copy of that complete paper, please contact her directly at dslane@berkeley.edu.

---

4 The “Alaska Scholars Award” uses class rank as its award criteria, and the “South Carolina Legislative for Future Excellence (LIFE) Scholarship” includes class rank in its criteria, along with GPA and SAT/ACT.
5 Author's calculations, based on figures from the NASGAP annual reports and data on numbers of both private and public high school graduates from the preceding years.
7 It is useful to note that, when a “new” funding stream outside the state’s general fund was used to support the merit aid program (often in the form of a lottery), it had a positive impact on per capita need-based aid. It is likely that this reversal in trends reflects that the state is not forced to dip into a pre-existing funding source in order to support the new merit aid program.
8 The current tuition at Harvard’s Kennedy School of Government for a MPP candidate is $28,584.00 annually, compared to $6,168.90 (including all fees) at UC Berkeley for California residents.
FROM THE EDITOR:
While the policy goal of need-based aid may be more important than the goal of merit aid, replacing merit aid with need-based aid may not be a politically feasible proposition in a society that places such a premium on hard work and capitalist ideals. The “American dream” is based on progress through hard work – the essence of merit aid. Shifting merit aid to need-based aid raises the specter of subsidizing mediocrity, rather than incentivising the best and the brightest. The results of Ms. Lane’s analysis are a tough sell.

FROM THE EDITOR:
Ms. Lane accurately identifies all publicly funded colleges and universities as merit aid programs. What’s interesting to notice is that while states like Georgia are enhancing their aid programs, our own state of California is moving in the opposite direction. Fees at all levels have increased significantly, and Chancellor Carnesale of UCLA is calling for a doubling of undergraduate tuition. Perhaps these states are responding directly to market pressures. Marketwise, the UC schools are already significantly oversubscribed, while other states like Georgia rely on programs like HOPE to maintain a strong interest from their top high school graduates. The laws of supply and demand dictate what these two states do. What we must be most afraid of, as Ms. Lane points out, is that poorer students do not get lost in the shuffle. Thus, Chancellor Carnesale appropriately plans to use some of the higher fees to subsidize lower income students. Is this fair to the middle- and upper-income students whose families are first taxed by the state and then taxed in the form of higher fees to attend elite public institutions? Should we, as a society, care about increasing their burden? By not investing more in higher education, a state is taxing its future.
**Subsidy and Sensibility: The Political Threats to Arts Funding**

**by Jacqueline Beaumont**

**THE EXISTENCE OF** the National Endowment for the Arts (NEA) was severely jeopardized in the 1980s and 1990s in a series of political battles known as the Art Wars. In 1995, the NEA responded to increased Congressional outcry – prompted in large part by controversial work by artists such as Robert Mapplethorpe – by ending all grants to individual artists. Concerns about offending public sensibilities, as well as arguments that government funding was unnecessary and a constraint on taxpayer freedom, spurred a House attempt to terminate the NEA in 1997. The wars came to a head in 1998, when the U.S. Supreme Court ruled in favor of a Congressional amendment stating that the NEA can consider decency, in addition to artistic merit, in deciding who gets public funding, without violating free-speech rights. Since then, annual appropriations have declined by almost a third from the 1992 funding peak.

The legacy of the art wars is the emergence of two competing standards for evaluating the value and direction of the NEA. One standard prizes the artistic merit of proposed projects, and proscribes the funding of art for art’s sake. The other focuses on the economic worth of arts funding and compares it to alternative public investments. The tension between these two standards has resulted in arts subsidies falling victim to budget politics and a push to fund the most popular arts.

The NEA allocation for 2004 was about $121 million, meaning that 42 cents is spent annually per American taxpayer. As John Miller of the *San Francisco Chronicle* notes, eliminating NEA funding completely would cover American expenses in Iraq for about half a day.

There are few federal programs that receive so little funding and yet attract as many attacks as the NEA. Still, President Bush’s proposal for an $18 million increase in the 2005 NEA budget (increasing the average cost per taxpayer to $0.49) has yielded over 40 major newspaper editorials and articles since January, in addition to numerous magazine and online journal commentaries.

When pressed, advocates for the NEA have found it difficult to develop a concrete economic rationale for arts funding that can withstand political pressures, even though economic analysis has supported the value of federal arts funding in several ways. Most members of American society agree that cultural awareness, creativity and arts education are important to society, independent of their economic benefits. Even if it were possible to confidently apply tools of economic analysis to the complex artistic and social values in question, it is improbable that the arguments would convince those on the opposite side of a politically charged debate.

While struggling advocates find it tempting to respond to labeling of arts funding as “waste” with economic facts and figures, the only argument that would allow the NEA to stay alive in its greatest form is to fight for art for art’s sake. In a way, this is a failure of the tools of economic analysis, but just as one would not use a pipe-wrench to paint a picture, one must recognize the limitations inherent in reducing creativity and inspiration to costs and benefits.

**Measuring the economic value of art’s funding**

As is often the case in questions of public funding, the proactive party seeking funding bears the responsibility of proving the economic merits of their reasoning. In attempting to prove the economic worth of public arts funding, advocates have used data to demonstrate that arts investment creates jobs and rakes in revenue from tourists. The evidence is not inconsequential. A growing two-thirds of American adult travelers include cultural activities while on a trip. These travelers stayed longer on average, often specifically because of the cultural activity, stimulating greater demand for local jobs.

Economic information also points to the value of arts education in a global economy as the design and creative aspects of today’s consumer products are becoming increasingly more important. America’s creative industries (comprising cinema, textiles and literature) were the nation’s leading export in 1999. Arts industries in some states are growing at a faster rate than the overall economic growth rate, something else for policymakers to consider in planning economic development activities. Finally, few Americans would guess that performing arts expenditures have increased such that Americans now spend more per capita on performing arts than on movie theaters or spectator sports.

When compared to other economic development options, arts investments are a miniscule line item in both federal and state budgets (often much less than one percent). However, dollars invested in state arts agencies result in up to ten-fold returns in in-state direct spending, due to job creation, tourism and expansion of money-making endeavors. Since the NEA’s creation, matching grant requirements of 1:1 (federal funds to state legislature funds) have spurred state funding in all 50 states that even exceeds federal funds in many cases. While NEA opponents cite the
majority of Americans who prefer local to state to national arts funding as a reason to cut national funding, the NEA's influence in maintaining state funding and its beneficial economic outcomes contradicts this argument.\(^\text{10}\)

That the arts are profitable, however, is not enough to justify public expenditure on economic grounds. In the absence of market failure, private actions should provide the right level of art investment. Some scholars argue that citizens who want art will buy it and citizens who do not will thus be freed of their taxpayer burden.\(^\text{11}\) However, there are strong reasons to doubt that artistic investment would take place at socially desirable levels in the absence of public action. The arts frequently show the properties and free-rider problems associated with public goods. Additionally, many Americans have little access to the arts, and therefore, some scholars maintain, do not have the exposure necessary to acquire the taste for the arts needed to make future purchases. Some scholars also argue that art is a “merit-good.” Essentially, this means that art contributes so much to society, and by its nature is so difficult to price, that subsidies must be provided in order for the arts to be distributed efficiently among an undervaluing American public.\(^\text{12}\)

### Why public arts funding is endangered

Despite economic reasons for arts funding, political motives and budgetary concerns threaten future funding. Since 1996, conservative research institutes including the Heritage Foundation and the Cato Institute have published at least thirteen lists of strategies to reduce wasteful federal spending that feature the elimination of the NEA among their top targets.\(^\text{13}\) In commentaries and testimonies, opponents have claimed that the NEA “at best competes with private philanthropy,”\(^\text{14}\) have framed the NEA budget in terms of the tax burden on families, and have portrayed its administrative budget as “unusually high.”\(^\text{15}\)

Arts funding is not a prominent issue for most voters. A meta-analysis of 13 major public opinion surveys on arts funding reveals that, while most Americans support the principle of arts funding, there is no hard support for increased federal funding.\(^\text{16}\) These and other findings can partially explain why NEA funding has been so controversial, despite its tiny apportionments: a core anti-funding minority (15-20%) often wins more airtime and political decisions than a weakly-committed pro-funding majority (55%).\(^\text{17}\)

There is significant opposition to NEA funding of “indecent” arts. While an overwhelming majority of Americans support free speech (95%), there is paradoxically far less support for “offensive” public speech, the type that our government has often viewed as most in need of protection and support.\(^\text{18}\) An opinion strongly held by many Americans is that taxpayers have the right to fund what they like, and should not be forced to spend their tax dollars on art they find offensive.

Sudden deficits and drops in revenue have forced various levels of government to trim their budgets.\(^\text{19}\) After the controversy of the Art Wars, politicians are now more able to compare arts budgets directly to other public expenditures, such as wildfire management\(^\text{20}\) and healthcare, currying favor with voters by not spending money on arts funding when budgets are tight.\(^\text{21}\) Raising the NEA budget by President Bush’s proposed $18 million would reinstate the level of funding only to 1978 levels (not adjusted for inflation).\(^\text{22}\) In the last two years, almost every state has passed severe arts budget cuts, citing the need to control budget deficits.\(^\text{23}\) These cuts come despite the fact that eliminating state arts agencies (which are usually less than 1% of a state’s total budget) will hardly close long-term state deficits; particularly when losses in jobs, tax revenue, and matching NEA funding are considered.\(^\text{24}\)

If public funding were eliminated, the oft-repeated claim that the arts would still be alive is probably true; the NEA, while America’s largest arts-funder, still only provides less than one percent of direct U.S. arts funding.\(^\text{25}\) However, there are important questions we should be asking ourselves about this transition, including: “Which arts would continue to be funded and which would not? Who would be able to enjoy the arts that do persist?” and “What will be the message to future Americans and artists if government funding disappears?”

### Art for art’s sake

In the National Foundation on the Arts and the Humanities Act of 1965, Congress states, “It is necessary and appropriate for the Federal Government to help create and sustain ... a climate encouraging freedom of thought, imagination, and inquiry.”\(^\text{26}\) The postwar need to prove superiority over the Soviet Union in every way, including the cultural front, probably also contributed to the NEA’s mission. For example,
the text asserts that the United States’ global position must be founded on the world’s “respect and admiration for the Nation’s high qualities as a leader in the realm of ideas and of the spirit.” While leadership and cultural heritage were among the principles behind Congress’ desire to fund the arts, the statute’s language at every turn praises the most creative, original and inventive properties of the arts, paying tribute to “wisdom and vision” of its citizens and, in commenting on its intentions, acknowledging that “no government can call a great artist or scholar into existence.”

Up until the 1980s, the criteria for arts funding seemed to be based on Congress’ original intentions.

As the Art Wars show, it is difficult to simultaneously satisfy the two competing standards for public arts investment—funding artistic vision and creating economic value—because these goals are not inherently compatible. These twin directives make it possible to only fund artists and organizations that are both visionary and value-generating.27

The “National Masterpieces” program proposed by President Bush this year is an example of such an endeavor. It plans to “combine arts presentations with education programming to introduce Americans to the best of their cultural and artistic legacy.” The press release smoothed programming to introduce Americans to the best of their cultural and artistic legacy. It plans to “combine arts presentations with education programming to introduce Americans to the best of their cultural and artistic legacy.” The press release smoothed programming to introduce Americans to the best of their cultural and artistic legacy.

Jacqueline Beaumont is a second year MPP student at the Goldman School of Public Policy and a first year law student at Boalt School of Law.

Subsidy and Sensibility - continued

17 Id.
Subsidy and Sensibility - continued

(endnotes continued from previous page)

26 National Foundation on the Arts and the Humanities act of 1965, Title 20, United States Code 951.

From the Editor:

Artistic merit and economic value are not mutually exclusive reasons for arts funding; quite the opposite, they reinforce arts funding. Arts funding produces neither purely artistic nor purely economic benefits, and determining arts funding levels based solely on either dimension would undervalue art. “Art for art’s sake” could be considered a positive externality of arts funding for economic benefits. The two justifications are completely compatible because they both promote arts funding – just at different levels than when each dimension is considered in a vacuum. As is usually the case in appropriations, the true friction in determining funding levels lies between interests competing for funding in different areas. Attributing arts funding levels to “art wars” does not minimize the fundamental reason for funding changes – good old-fashioned budget politics.
It’s hard to listen to a politician or pundit these days without hearing that America is “losing jobs” to poorer nations – manufacturing jobs to China, back-office work to India, just about every job to Latin America. This lament distracts our attention from the larger challenge of preparing more Americans for better jobs.

Most job losses over the last three years haven’t been due to American jobs “moving” anywhere. They’ve resulted from an unusually long jobs recession which, hopefully, is coming to an end. We can debate whether the Bush administration has done enough, or the right things, to accelerate a jobs recovery. But job growth eventually will resume, as aggregate demand bounces back.

It’s true that U.S. manufacturing employment has been dropping for many years, but that’s not primarily due to foreigners taking these jobs. Factory jobs are vanishing all over the world. Economists at Alliance Capital Management took a look at employment trends in 20 large economies and found that between 1995 and 2002, 22 million factory jobs had disappeared. The U.S. wasn’t even the biggest loser. We lost about 11% of our manufacturing jobs in that period, but the Japanese lost 16% of theirs. Even developing nations lost factory jobs: Brazil suffered a 20% decline, China a 15% drop.

What happened to factory jobs? In two words, higher productivity. I recently toured a U.S. factory containing two employees and 400 computerized robots. The two live people sat in front of computer screens and instructed the robots. In a few years this factory won’t have a single employee on site, except for an occasional visiting technician who repairs and upgrades the robots, like the gas man checking your meter.

Manufacturing is following the same trend as agriculture. As productivity rises, employment falls because fewer people are needed. In 1910, a third of adult Americans worked on farms. Now, fewer than 3% do. Since 1995, even as manufacturing employment has dropped around the world, global industrial output has risen more than 30%. In China, modern factories are replacing inefficient state-sector plants. China produces more goods than ever before, but millions of Chinese factory workers have lost their jobs.

We should stop pining after the days when millions of Americans stood along assembly lines and continuously bolted, fit, soldered or clamped what went by. Those days are over. And stop blaming poor nations whose workers get very low wages. Of course their wages are low; these nations are poor. They can become more prosperous only by exporting to rich nations. When America blocks their exports by erecting tariffs and subsidizing our domestic industries, we prevent them from doing better. Helping poorer nations become more prosperous is not only in the interest of humanity but also politically wise because it lessens global instability.

Want to blame something? Blame new knowledge. Knowledge created the electronic gadgets and software that can now do almost any routine task. This goes well beyond the factory floor. America also used to have lots of elevator operators, telephone operators, bank tellers and service-station attendants. Most have been replaced by technology. Supermarket check-out clerks are being replaced by automatic scanners. The Internet has taken over the routine tasks of travel agents, real-estate brokers, stock brokers and accountants. With digitization, high-speed data networks and improved global bandwidth, a lot of back-office work can now be done more cheaply abroad. Last year, companies headquartered in the U.S. paid workers in India, China and the Philippines almost $10 billion to handle customer service and paperwork.

Any job that’s even slightly routine is disappearing from the U.S. But this doesn’t mean we are left with fewer jobs. It means only that we have fewer routine jobs. When the U.S. economy gets back on track, many routine jobs won’t be returning — but new jobs will take their place. A quarter of all Americans now work in jobs that weren’t listed in the Census Bureau’s occupation codes in 1967. Technophobes, neo-Luddites, and antiglobalists be warned: You’re on the wrong side of history. You see only the loss of old jobs. You’re overlooking all the new ones.
Nice Work If You Can Get It - continued

involves identifying and solving new problems. Here, workers do R&D, design and engineering. Or they’re responsible for high-level sales, marketing and advertising. They’re composers, writers and producers. They’re lawyers, bankers, financiers, journalists, doctors and management consultants. I call this “symbolic analytic” work because most of it has to do with analyzing, manipulating and communicating through numbers, shapes, words, ideas. This kind of work usually requires a college degree.

Over the long term, symbolic analysts will do just fine, as long as they stay away from job functions that are becoming routinized. They will continue to benefit from economic change. Computer technology gives them more tools for thinking, creating and communicating. The global market gives them more potential customers for their insights. To be sure, symbolic analysts are popping up all over the world. More than half of all Fortune 500 companies say they’re outsourcing some software development or expanding their own development centers outside the U.S. But apart from recessions, demand for symbolic analysts in the U.S. will continue to grow faster than the supply.

No other country does a better job preparing its citizens for symbolic analysis. Our universities are the envy of the world. And no other nation surpasses us in providing on-the-job experience within entire regions specializing in one or another kind of symbolic analytic work (New York for finance, L.A. for music and film, Silicon Valley and greater Boston for science and bio-med engineering, and so on). Besides, there’s no necessary limit to the number of symbolic analytic jobs because there’s no finite limit to the ingenuity of the mind or to human needs.

The second growing category of work in America involves personal services. Computers and robots can’t do these jobs because they require care or attentiveness. Workers in other nations can’t do them because they must be done in person. Some personal-service workers need education beyond high school — nurses, physical therapists and medical technicians, for example. But most don’t, such as restaurant workers, cabbies, retail workers, security guards and hospital attendants. In contrast to that of symbolic analysts, the pay of most personal-service workers in the U.S. is stagnant or declining. That’s because the supply of personal-service workers is growing quickly, as more and more people who’d otherwise have factory or routine service jobs join their ranks. Legal and undocumented immigrants are also pouring into this sector.

But America’s long-term problem isn’t too few jobs. It’s the widening income gap between personal-service workers and symbolic analysts. The long-term solution is to help spur upward mobility by getting more Americans a good education, including access to college. Unfortunately, just the opposite is occurring. There will be plenty of good jobs to go around. But too few of our citizens are being prepared for them. Rather than fret about “losing jobs” to others, we ought to be fretting about the growing number of our young people who are losing their footing in the emerging economy.

Robert B. Reich was a visiting professor at the Goldman School of Public Policy in Spring 2004, where he taught a seminar class on ‘Wealth and Poverty’.

Robert B. Reich is University Professor and Maurice B. Hexter Professor of Social and Economic Policy at Brandeis University and at Brandeis’s Heller School of Social Policy and Management. He has served in three national administrations, most recently as secretary of labor under President Bill Clinton. He has written ten books, including ‘The Work of Nations,’ which has been translated into 22 languages; the best-sellers ‘The Future of Success’ and ‘Locked in the Cabinet;’ and his most recent book, ‘Reason.’
ProFESSOR REICh IS correct to point out that the “outsourcing” debate distracts us from the real challenge of preparing the American job market for the challenges that lie ahead. In fact, as many economists (such as Hal Varian of UC Berkeley) point out, micro examples of firm outsourcing have the macro effect of moving the American economy up the “value chain” and toward more skill-based production processes. This benefits consumers and firms alike, but gets workers in outsourced industries (such as manufacturing) nervous. Rightly so - the real life consequences of the jobless recovery are not just a rising rate of unemployment, but also longer average unemployment duration and lower wage replacement upon employment.

The modern American worker is thus besieged, and in an election year the blame game is in full swing. Senator Kerry’s talk of “Benedict Arnold CEOs” is tempting and politically expedient, but nevertheless stumbles upon another of the campaign season’s “inconvenient truths”: that the sluggish job market has little to do with the replacement of domestic labor with foreign labor and everything to do with the substitution of labor with capital.

Let’s take the biggest foreign bogeyman: China. America’s large trade deficit with China ($124 billion and counting) is fueled by our increased importation of Chinese manufactured goods. But it does not follow that this increase has replaced domestic production – rather, it has been at the expense of other emerging economies, so that America buys goods from China now rather than Taiwan, South Korea, or Hong Kong. And even these countries have not lost out. Instead, they have also moved up the “value chain” – and thus does the global economy motor along.

So if we cannot blame foreign replacement of manufacturing jobs, how else to explain the “jobless recovery”? We must look within our own borders, and at our own companies. Reich’s factory tour and other more apocryphal stories are smaller parables in a greater tale of transition for the American labor force. Outsourcing – or its less politically problematic euphemism, moving up the value chain - is one part of the transition, but the bigger and more significant part has been the dramatic shift from labor-intensive to capital-intensive production by American companies.

In large part, this transition has been fueled by technological change, or “new knowledge,” if you prefer. Such change has the air of inevitability, but while the routinization of previously human tasks will continue unabated, the “jobless recovery” is a real, but recent phenomenon that need not be the unfortunate consequence of innovation. In the graph below, we can see that despite the rapid technological improvements of the 1990’s boom, redistribution of the economic pie did not accelerate until recently.

**Selected Component Shares of National Income**

![Graph showing selected component shares of national income.]


Why has this happened? While Democratic loyalists might rightly cry foul at tax cuts, the answer has more to do with the economic climate in which business investment is made. When the economy is in recession, many companies accumulate large stores of cash and hold onto it until the business climate improves – General Motors, for example, had almost $8 billion on hand in 2001, and yet did not increase its level of internal investment or employment. This is because during recession, companies suffer principally from a lack of demand for their products, and are therefore likely to cut costs at the margin. Even when economic conditions improve, companies are likely to be risk-averse when it comes to new investment.

Investment in capital (rather than labor) has become more mobile and flexible, and in uncertain economic times this is a definite advantage. If a company wants to grow, it can either make a scale investment (more computers) or a productivity investment (a faster processor for the computer), for example. A similar parallel exists for labor, or “human capital”: the firm can either hire more workers, or invest in education and/or training to increase worker productivity.

These days, firms are choosing productivity investments over scale investments – “high value” rather than “high volume” – but such investments are more risky with labor than with capital. In financial terms, investment in human
capital productivity is “illiquid” – firms (or individuals, for that matter) cannot sell back their investments in education and training once undertaken, and so human capital investment becomes a much riskier proposition. Furthermore, the increasing sophistication of financial markets widens the gap in “search costs” between new capital and new labor. Even taking technological improvements as given, this growing disparity contributes to relative underinvestment in labor. Consequently, because firms are more reliant on capital investment, this gap also increases the elasticity of firms’ demand for labor, which exacerbates wage inequality.

Despite Senator Kerry’s campaign rhetoric, we can hardly blame businesses, which are simply reacting to incentives and ensuring their own survival. Rather, as Reich says, we must work to increase the value of our “human capital,” so as to make it irreplaceable. Flogging of CEOs aside, it is perfectly understandable that the illiquidity of human capital makes firms reluctant to invest in it. Indeed, while the promotion of high value, “symbolic analyst” jobs may be the route to job recovery, this is exactly the kind of investment that we cannot expect companies to willingly undertake. Unlike on-the-job training for manufacturing jobs, “symbolic analytic” training is more transferable and thus makes an employee more attractive to other firms. Any rational, cynical economist will tell you that the less firm-specific the human capital investment, the less likely it is that the firm itself will chip in.

The illiquidity of human capital investment has consequences for workers as well. Because a potential college student cannot “sell back” her investment once made, she undertakes a substantial risk that is offset only by the high returns traditionally offered on a college education. If businesses continue to rely on physical capital investment rather than on labor, the expected rate of return on education lowers, creating a self-reinforcing cycle that could have long-term negative consequences for the job market.

Thus if businesses cannot be counted on to invest in the development of “symbolic analysts,” and if workers themselves face too much risk, who is left to address the problem? You guessed it – Uncle Sam to the rescue. For those laissez-faire types who disdain government intervention in the market, be advised that the current tax treatment of firm investment is already tilted heavily against labor. The least we can do is correct the imbalance and invest in education, which generates a positive externality for society. Certainly, past government intervention in markets has not always worked, but that could just as easily be an argument for better government. In fact, the great Milton Friedman pronounced human capital illiquidity a “market failure.” And as students of his intellectual (but not genetic) progeny Lee Friedman know, a better case for government intervention one cannot make.


David Deming is a second year MPP student at the Goldman School, and Co-Founder and Executive Editor of PolicyMatters. He is here continuing his strange and quixotic fascination with human capital, and he preferred the original title of the piece, “The Man is stealing our money to buy robots that take our jobs - An Ode to the Knowledge Economy.” He is a proud symbolic analyst, and lives in San Francisco.