EconoFact Chats: The State and Your Hard-Earned Money
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Published on Sunday, November 8th, 2026

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I'm Michael Klein, executive editor of EconoFact, a nonpartisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
Paolo Mauro begins his new book, *The State and Your Hard-Earned Money*, with some deep questions: How much of your hard-earned money is it fair for the state to collect through taxation? What public services should the state use the money for? He then writes, "government choices regarding public expenditures or taxation reflect, implicitly or explicitly, moral points of view." It's rare for an economics book to so explicitly bring up morality, and even more unusual for a book about economics to devote a long chapter to moral philosophy that refers to Immanuel Kant, John Rawls, Michael Sandel, and Robert Nozick. But Paolo notes that the early economists, like David Hume, Adam Smith, Jeremy Bentham, and John Stuart Mill, were also moral philosophers. And, as Paolo points out, questions about public finance and the role of government in the economy must address issues of equity and fairness, as well as efficiency in revenue collection. Paolo is the Director of the Development Impact Measurement Department of the International Finance Corporation. He spent three decades at the International Monetary Fund working on macroeconomic and fiscal issues, and has been a senior fellow at the Peterson Institute for International Economics and a visiting professor at Johns Hopkins Carey Business School. Paolo, welcome to EconoFact Chats, and congratulations on the publication of your new book.

Paolo Mauro
Thank you, Michael. And you mentioned that I cite a lot of famous philosophers from the past, but I want to just add that there's a lot of exciting modern research in these areas, so I cover that as well. Thank you.

Michael Klein
Yeah, I really enjoyed that chapter of the book and, you know, it's different from what I usually read, but I learned a lot from it. And Paolo, you note that much of economics is concerned with the efficient use of resources rather than equity of outcomes, and economists tend to analyze the consequences of different policies, but then they say that the choice among them should be left to the political process. In the 1960s, the economist Arthur Okun framed a way to think about the tradeoff between equity and efficiency with the metaphor of a leaky bucket. You discuss this in the book. What's the idea behind this metaphor?

Paolo Mauro
Yeah, so the famous leaky bucket. So the idea is that if you have a rich family and a poor family, the government can transfer $100 from the rich family to the poor family. But because of inefficiencies, which are symbolized by the metaphor of the leaky bucket, in transferring money, the poor family does not get

the full $100 – it might get only $90. And this is a way to elicit people's preferences regarding how much aversion they have to inequality. So I might say, “well, look, if you're going to lose $10 along the way, it's not worth making this transfer.” So it's a very interesting approach, and economists have used it. The problem is that when we have done these exercises, we've never really thought very hard about who those families are. And so the assumption has always been that, it's coming from a so-called universalist perspective, where everybody's the same no matter what. But, you could ask – what happens if those families are from different nations, or if they have different ethnicities, or different religions?

Michael Klein
Yeah, you make the point several times in the book about two different perspectives on morality. And one of those, as you say, is universalist, and the other is what you call ‘communitarians.’ What are the two different approaches to equity and fairness of these two different ways of thinking about it?

Paolo Mauro
Yeah, maybe it's useful to step back for a moment and say where this is all coming from. So there have been some very interesting developments in moral philosophy coming from psychologists who have realized that our perspectives on morality are shaped by evolution. And perhaps the most striking finding is that we evolved as roving bands of hunter-gatherers, and in order for these bands of hunter-gatherers to cooperate, they had to have feelings towards each other, and that's how morality evolved. It was a way of enforcing collaboration. Now, that leads us towards communities. And in the Western tradition, there's an approach which is more universalist, which basically goes to the golden rule – treat others the way you want to be treated. But what's missing from there is that feelings also inform our moral perspectives, and many people have stronger feelings of belonging, of loyalty, to particular groups. So in the spectrum, you have some people who are more universalist, who love to give international aid, and then you have people who are more communitarian, who care more about their neighbors – people with the same religion or same ethnicity. Those are communitarians. And a lot of the debates that we have are shaped by that interaction.

Michael Klein
Yeah, there's a famous saying attributed to Rabbi Hillel when he was asked, "can you describe the entire Torah while standing on one foot?" And he said, "do unto others as you would have them do unto you, and the rest is commentary." So that's a good example of the universalist view. But of course, as you say, people are interested in concentric circles of…you're more interested in your family than others, you're more interested in your community than people way outside your community, and so on. So, Paolo, what are the practical applications of these differences?

Paolo Mauro
Right. So the way I go through it in the book – and I give a lot of more nuance and more detail on these approaches; in fact, the moral philosophers themselves don't talk just about globalists versus communitarians. It's also something about loyalty and authority and what they call sanctity or purity. So let me give you a concrete example. Apparently, one of the things that have come through evolution is our feelings of discomfort when we see something that seems polluted. And this is something that can be

leveraged in debates on things like environmental regulations or climate change. If you can make the case that we need to go back to a clean environment – for example, in the US, there's a long tradition of going back to nature, with Thoreau, with Aldo Leopold…that could be useful in making the case for certain policies. Likewise, if you're talking about reducing the public debt, the notion of leaving a fiscal house in order, or sort of cleanliness in your public finances, that's helpful to bring more people to support those policies.

Michael Klein
So you're discussing ways in which appealing to these very deep feelings and emotions of people is a way to think about the morality of these issues. And lately, issues of fairness have been animated by increased inequality. There are different types of inequality. You write about inequality of income, inequality of wealth, and inequality of opportunity. How are these related to each other?

Paolo Mauro
Right. So conceptually, of course, you can separate them. But what I argue in the book, and I go through some examples – is that it is actually hard to keep them separate in the real world, in the data. And there's a lot of empirical analysis that I go through. But let me just give you a simple example. It's not a real, real-world example, but I think it might resonate. So suppose you've got two young professionals, both highly trained, top school, very hard working, and they're in a very prestigious firm working together. And one of them becomes ill with a very serious illness, and has to take off a whole year from work. Her family is wealthy, and she gets support from the best specialists, and after a year, she goes back to work, she's fully functional, and she does very well. The other one is perfectly healthy and, you know, good performer, strong performer. But unfortunately, her family has some issues, and in particular, her mother has some mental health issues and keeps calling her at work and wants money from her. And in that environment, this young professional is a good performer, but not a stellar performer. She's about average. Now, three years later, the company goes through a downsizing. And, you know, the managers look at the performance of these two young professionals. One had an illness, but came back and was very good. And the other did not have an illness, but was always a little bit distracted at work and was an average performer. In the end, the second one is the one that gets laid off. And, this is an example of how you have people who seemingly have the same opportunities, but then the wealth of the family infringes upon that. And so kind of history matters. So there's a lot of these nuanced examples and analysis in the book that we can go through.

Michael Klein
Well, wealth matters. And as you and other people have pointed out, wealth inequality has grown tremendously over the past half century. You point out that the very richest people in the United States have a very disproportionate amount of wealth, and that disparity is growing. The wealth of the top 1% increased from 25% of all wealth in the 1970s to 40% today, and at the same time, the bottom 50% saw their wealth drop from one-fifth of all wealth to one-eighth today. What are some of the sources of this rising wealth inequality?

Paolo Mauro
Well, there's a lot. One is automation. One is globalization. I think there is a lot of…technology has a lot to do with this. What happens in certain industries is that you have network effects. So some of the firms – and, just look at the stock market today, the famous "Magnificent Seven" – there's a lot of concentration. Some of these firms are spectacularly successful. And there are also features of the tax system, as I explain in the book, that support these trends towards greater inequality. What you see in terms of the facts is there's enormous inequality at the very, very, very top of the distribution, particularly in the United States, particularly in the United Kingdom, but rising inequality in many advanced economies. In some other countries, that's not the case. There has been a reduction in inequality. And I always like to also point out that global inequality has gone down. So if you line up all of the people in the world from the poorest to the richest, that inequality – and you don't care about national borders – that inequality has gone down. But in the zeitgeist and in the suffering of many people in many advanced economies, there's a lot of prominence to inequality. And I think also there's a lot of concern about the way in which this inequality has emerged. There are perceptions that not everybody has the same opportunities, the system is rigged according to some, there are concerns about corruption. So you see people demonstrating in both advanced and low-income countries.

Michael Klein
So higher inequality is not necessarily related to greater poverty. And you can imagine a situation where the poor, who are brought out of poverty by their rising incomes, but at the same time, the incomes of the rich are rising even faster. So this would be a situation where we have decreasing poverty alongside increasing inequality. So why should we be concerned with inequality rather than poverty?

Paolo Mauro
Right. So I think that, indeed, you could separate conceptually the two things: poverty and inequality. And by the way, we're doing terribly when it comes to fighting poverty. I mean, if you look at child poverty, it's really something that is extremely sad. You know, policies are in place, there are efforts, but we're still not doing well. There are hundreds of millions of stunted children with permanent damage to their both mental and physical growth. So we're really not doing well in that regard. And we've learned a lot about how to provide cash transfers, how to support families, including through digital transfers, so there's a lot that can be done in that area. This is not to negate the suffering of people who see inequality in the sense that some members of the middle class have not seen any growth in their real incomes for many years. So both aspects to me are super important to look at.

Michael Klein
Yeah, the issue of child poverty is a very compelling one. We have some work by Melissa Kearney, who points out that the child poverty rates fell dramatically during COVID, even when the economy was weak, because of the increase in government transfers. But when those ended, the child poverty rates went back up again. So it does seem to be, in many ways, a government choice, not just sort of a state of nature.

Paolo Mauro
That's right. And sorry to interject, but we've learned a lot during COVID about what works, what doesn't work, new ways of deploying transfers, and all that. So in some ways, that's a useful learning opportunity.

Michael Klein
So how is inequality perceived? Is it seen as something that is fair or not fair? And what are the sources of this idea of the fairness, if you will, behind inequality?

Paolo Mauro
So a couple of things. One thing that I found super interesting was that if you do surveys—and I didn't do surveys myself, I just summarized what academics have found by looking in a wide range of countries—what you find is that people's attitudes towards inequality do depend on the source of inequality. And even there, there are differences. So, for example, in some Asian countries, people don't seem to mind inequality that results from luck – inheritance or, you know, even the lottery. Whereas in the West, we tend to be a little bit more understanding of inequality that stems from differences in effort or talent, but we are less favorable towards inequality that stems from inheritance or luck. So that's something that I thought was very interesting. I think the broadest pattern that I observe is that what people don't like is inequality that stems from either lobbying to get special treatment from the government, or outright corruption.

Michael Klein
Yeah, in the recent election, corruption was cited as one of the things that was really driving voters. And people, as you say, don't seem to mind so much that LeBron James makes so much money because he's an incredibly talented and hard-working person. But if you're doing it through corrupt means, where you're trying to influence government decisions, that's seen as much worse. Well, Paolo, what about different government programs to address inequality? We have a progressive tax system. There have been calls for reforming the inheritance taxes, though in California the vote against the billionaires' tax failed. While these may be seen as creating a more fair economy by some, others would argue that people have a right to what they've earned, and furthermore, these policies might be ineffective at best, and people might find ways around them, or they could diminish incentives and the dynamism of the economy. I guess in a way this goes back to the leaky bucket idea, right?

Paolo Mauro
Yes. So a couple of things here. One is there's a whole chapter in the book where I trace the history of how both the activities and the notion of what the state should be doing in terms of public services and so on has evolved over the years. And, for example, in the 1900s, the state was essentially defense, and defense spending and a little bit of basic services. But then during the 1900s, as economies grew, you see the state taking on more and more roles – unemployment benefits, so the state becomes an insurer. The state becomes a lender of last resort with the Great Depression. You get Social Security, pension systems, which are one of the main drivers of expenditures, and you know, with aging, that will continue. So there's a lot that the government does for people, and people are, I think fairly, expecting more efficient services,

including—and here I'm speaking globally—healthcare, education to keep up with new technologies, and so on. The other thing I will say is that when there are these big crises, like the Great Depression or like COVID, you have exceptional interventions by the government, and then somehow the whole notion of the state changes as a result. So you have some ratchet effect after the Great Depression…after the wars, to support people who had gone to war and, you know, when they come back into civilian life, they have to be brought back successfully, so they need government support. Ditto for COVID. We saw a lot of interventions, and I document that and say a little bit about what we've learned from there. So definitely this is a very dynamic area. And on the tax side, on things like wealth taxes, we could say a lot. Maybe I'll just mention a couple of things. One is that for a wealth tax to be successful, you need international cooperation, because otherwise firms will migrate, individuals will migrate. So cooperation among states, if it's the United States, but perhaps even more importantly, cooperation among nations is the only way in which you can muster sufficient resources. And then, of course, on wealth taxes, there's a lot more that we could say. One very quickly…I think many economists think that you can achieve the same goals of a wealth tax through better income taxation, through, for example, higher taxation of capital gains and reducing some loopholes. But then you still have the stock problem of people who have large wealth already accumulated, and, you know, that has political implications as well.

Michael Klein
Yeah, we have a relatively new EconoFact explainer by Bill Gale and John Sabelhaus about the coming big transfer of wealth as baby boomers age and pass on their wealth to their children, and how to tax that wealth, and how it should be taxed, how it could be taxed, and so on. But Paolo, I want to continue with this idea about the role of the state. The title of your book, *The State and Your Hard-Earned Money*, can be read in a way that misses the point that anybody's hard-earned money is made possible through the state and its provision of things like infrastructure, education, and the rule of law. And of course, you know, there's also people can earn money less legitimately by favors granted by the state. They may be legitimate and within the law, although they may also reflect lobbying to receive favorable treatment. Do you think there is insufficient acknowledgement of the role the state plays in creating an environment where people in fact can do their jobs and earn their incomes?

Paolo Mauro
Well, I think, you know, if you look at surveys around the world, people say they want more healthcare, they want more education, in some cases they want more defense or border control, and again, this depends on their particular moral perspectives. So I think people do understand. At the same time, I don't think there's a whole lot of deep understanding of how much the government is already supporting them. So in some surveys, people don't even seem to be aware of how many government services they're already benefiting from. I mean, the caricature is people who don't know that Medicare in the United States is something that comes from the government. And I think, you know, that's a caricature, but that goes internationally as well, and I talk a little bit about it in the book.

Michael Klein
Yeah, there's that—I don't know if it's apocryphal or not—the bumper sticker: "Keep government hands off my Social Security."

Paolo Mauro
Indeed.

Michael Klein
So we talked earlier about the different views of globalists and communitarians. Do you see any areas where they would agree?

Paolo Mauro
Yes, absolutely. In fact, that's something that I develop quite a bit in the book. I will also make a pitch for not just focusing on this distinction between globalists and communitarians, but particularly for researchers and for students, I would encourage them to think also – and in the book there's a lot about these different aspects of what resonates more with communitarians, again, things like loyalty, authority, purity. Those are aspects of morality that can be studied more. But I do see some obvious points of agreement. And again, the one that—perhaps because I did so much work on it in the past—but the one that I think is definitely an area of agreement is corruption. And there's a lot that can be done to develop a coalition, if you will, of people who are all interested in action against corruption. I talk about some of the challenges in that area. The one angle that I want to add to this is that, paradoxically, exactly because in the fight against tax evasion, corruption, and so on, you need international cooperation. You need international cooperation for tax policies, but also for tax administration, to avoid tax avoidance, to eliminate opportunities for money laundering. Exactly because of that, even the communitarians, who are not very keen on international cooperation, at some point they will need to accept a good amount of international tax cooperation, or international cooperation in general, because that's the only way that they can muster the fiscal resources that can then be deployed to support their own communities.

Michael Klein
Well, I think it's useful to end on a point that we live in an integrated world, and even local outcomes are affected by what happens more globally. So, Paolo, congratulations again on the publication of *The State and Your Hard-Earned Money*, and thank you very much for taking the time to speak with me today.

Paolo Mauro
My pleasure. Thank you so much, Michael.

Michael Klein
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