THE WRONG WAY TO FIGHT INEQUALITY

If the left wants to reduce inequality, they are going about it the wrong way.

Poverty and inequality have become increasingly pressing issues, and politicians have scrambled to propose solutions to the consistent upward march in poverty rates across OECD economies since the mid-1990s. Many of these proposals involve deepening government intervention in the economy through increased spending and more regulation. But increased government action is likely to make the problem worse.

The poverty rate used by the OECD is a measure of relative rather than absolute poverty, with the poverty line being defined as half the median household income of the total population. Since 1995, the poverty rate across OECD economies increased from 10.1 percent to 11.7 percent in 2011. Many countries have seen even more significant changes, with Sweden's poverty rate jumping from 3.7 percent to 9.7 percent. But there are substantial differences in poverty rates from country to country within the OECD—from 20.9 percent in Israel to 6 percent in Denmark—and these differences likely reflect different policies and institutions.

Much of the discussion around poverty has centred on the amount of government taxes and spending, a narrow view of the issue that lends itself to simplistic and ineffective solutions. Proponents of passive welfare argue that transfers from the rich to the poor are the simplest ways of reducing poverty, but this assumes that the GDP of the economy is exogenous to taxes and spending. Taking the level of economic activity as given and increasing transfer payments to those below the poverty line will undoubtedly alleviate poverty for some in the immediate term. However, the more that a government taxes, the larger the distortionary impact of these taxes on the private sector and the greater the negative effects on economic growth.

Economic growth is key both to job creation and rising wages, which is especially important for low income earners whose income is largely determined by wage earnings. In the long run, economic growth raises incomes for the poorest members of society just as much as for the rich, according to World Bank economists David Dollar and Aart Kraay. They also found that reductions in the overall size of government not only increase growth but also increase the income share of the poorest fifth of society.

Less Regulation, More Jobs

Regulation is rarely mentioned in connection with poverty, but it pays a critical role in how governments impact and control the economy. Figure 1 demonstrates the link between the extent of regulation and the poverty rate for sixteen OECD economies. The Product Market Regulation indicator measures the degree to which policies promote or inhibit competition across the economy and includes the degree of state control and barriers to entrepreneurship. A higher score indicates more government oversight of the economy and, as can be seen in the graph, is associated with a higher poverty rate.

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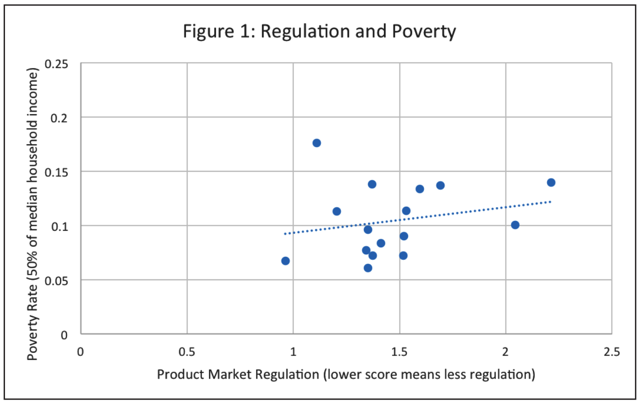

Figure 1: Regulation and Poverty

Figure 2 establishes a relationship between the difficulty of setting up a business and the poverty rate. When it is harder to start a business due to increased regulation and bureaucracy, the level of poverty in an economy is generally higher.

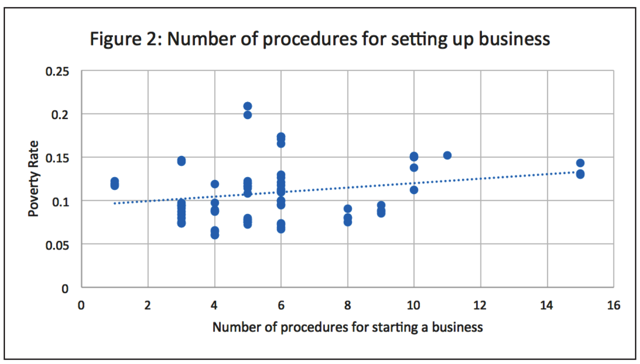

Figure 2: Number of procedures for setting up business

Figure 3 displays how an increase in the cost of registering a business is linked with a higher poverty rate. To normalise the cost of business start-up procedures, they are presented as a percentage of gross national income per capita.

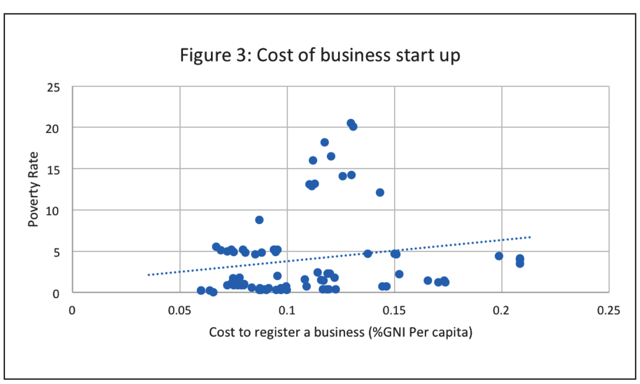

Figure 3: Cost of business start up

Regulation and bureaucracy appear to have significant negative effects on the level of poverty in many developed economies. This is most likely because government regulation and bureaucracy absorb the resources of private individuals and businesses and prevent resources from being used in the most efficient manner.

Job Creation

One of the central issues in reducing poverty is creating jobs. Without jobs, people remain trapped in poverty and reliant on government. The primary engine of job creation is business, so the starting point for governments should be to create an environment that allows business to thrive.

Governments can and do play a vital role in assisting businesses by ensuring that private property rights and the rule of law are respected and by providing the right infrastructure such as roads and ports. However, if the government builds a large bureaucracy and imposes substantial and complex regulation, this will hamper job creation by increasing costs and erecting barriers to business expansion. This administrative burden can also deter new businesses from forming.

Inflexible or costly hiring and firing regulations are often an obstacle to employment, with economies that have strict labour market regulations having higher unemployment. Once a person is out of work in a rigid labour market, it becomes difficult for him to find employment again, especially given firms' reluctance to hire when regulations impose significant costs. The unemployed begin to lose qualifications relative to the employed, which can cause unemployment to become persistent and result in dependence on government handouts.

Two aspects of regulation and bureaucracy that are often overlooked are rent-seeking and regulatory capture. Rent-seeking involves individuals and businesses obtaining a share of wealth already created without creating any new wealth themselves. The more regulation and bureaucracy there is, the higher the returns to rent seeking.

Businesses can lobby governments to impose regulations on competitors or erect barriers to entry in order to increase their own market share. Bureaucrats can solicit bribes for using their authority to award benefits. The larger and more complex the bureaucracy, the easier this process becomes. When economists Ismail Cole and Arshad Chawdhry compared several U.S. states according to levels of rent-seeking activity—as indicated by size of government bureaucracies and number of special interest groups or lobbyists—they found these factors to have a strong negative effect on economic growth.

Regulatory capture occurs when a regulatory agency that is designed to act in the public interest instead advances the concerns of interest groups in the sector it is charged with regulating. Regulatory capture can enable rent-seeking and can negatively impact effective governance. Another problem is increased uncertainty surrounding licenses and permits when these are given out at the discretion of bureaucrats, who may not be acting in the public interest.

All these factors can harm the overall ability of firms to invest, which in turn leads to more households falling below the poverty line. The larger the size of government bureaucracy, the more likely it is that firms will divert resources from creating employment opportunities and increasing wages towards manipulating government regulation to reward themselves at the expense of the rest of the private sector.

Foreign Direct Investment

Foreign direct investment has long been recognised as beneficial to growth, with higher levels of foreign investment leading to higher levels of economic activity. Figure 4 demonstrates the positive relationship between restrictions on foreign direct investment and the poverty rate. This is not surprising, given that restrictions on foreign investment act to deter businesses and multinationals from investing capital into countries and creating economic opportunities. Foreign investment into countries is also often a sign that investors believe that the country's economy will expand and that their investment can help realise that future prosperity.

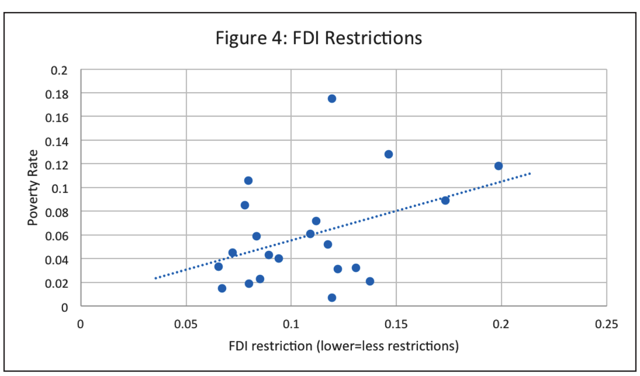

Figure 4: FDI Restrictions

The Right Way to Reduce Poverty

There are many reforms that governments can implement that will both reduce poverty and increase economic activity:

- Lowering the costs of doing business by lowering minimum capital requirements for starting a business and simplifying the procedures for firm entry and exit.
- Making labour markets more flexible by reducing the costs of firing workers and introducing non-standard contracts.
- Linking welfare benefits with employment and work, thus increasing incentives to join the labour force and engage in gainful employment.
- Getting the poor into work and then decreasing benefits gradually.

Despite what many politicians have suggested, increasing the size of government is not the solution to the recent growth in poverty rates across the OECD. Imposing more government control over economies, particularly those already suffering from large bureaucracies and burdensome regulation, will have a detrimental effect on economic growth and cause poverty to increase. Governments should instead make it easier for businesses to create jobs by removing rigidities in the labour market, lowering the costs of starting a business, and tying welfare benefits to employment. Only by joining the labour market can individuals free themselves from government dependence and poverty.