

The Rising Tide

Answering the Right Questions in the Inequality Debate

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Executive Summary

In a companion paper, “People Not Ratios: Why the Debate over Income Inequality Asks the Wrong Questions,” we argue that many inequality activists have been asking and answering the wrong questions in their quest to help the poor. Instead of analyzing the mathematical ratios between high and low incomes, poor people are better served by higher living standards. This paper proposes a policy agenda to raise living standards for poor people around the world.

We begin by looking at two policies currently popular with many anti-poverty activists, and find them wanting: the minimum wage and expanded collective bargaining.

Minimum wages benefit some workers, but come with tradeoffs that hurt others. The bleak litany of tradeoffs includes, but is not limited to: firings; hour cuts; reduced or eliminated non-wage perks such as insurance, vacation days, and complimentary parking and meals; lower annual bonuses; and reduced purchasing power due to higher prices. Moreover, some workers are never hired in the first place, and these willing workers are disproportionately young and minority. No amount of wishing can make these unintended consequences go away. Intentions are not results.

Collective bargaining has a similar effect. Some workers benefit, but only at other workers’ expense. Just as corporations and public officials work to benefit themselves rather than consumers or the public, unions work to benefit their own members, not all workers. The benefits unions accrue for their members come at a cost to everybody else. Collective bargaining does not create new wealth. Rather, it transfers existing wealth away from consumers and non-union members—and in the case of government unions, away from taxpayers—toward unions and their members.

After analyzing these two misses, we look at hits: policies that actually do help the poor. This requires making an important distinction: *absolute* poverty versus *relative* poverty. Relative poverty looks at ratios—the pay differential between a CEO and her secretary, for example. Absolute poverty is concerned instead with people’s actual living standards—can the secretary afford decent housing and a good education for her children? Many poverty activists are so concerned with ratios and relative poverty that they forget about absolute poverty and quality of life.

Fighting absolute poverty begins with two fundamentals. The first is an honest price system. The second is a framework of institutions that protect entrepreneurship, openness, and commerce.

There are several possible ways to institute an honest price system. In most countries, a central bank manages the local currency. It is important to bind these banks with predictable rules to prevent panic during a recession or a financial crisis. Our point is not so much which rule a central bank should adopt, but that *it must have a rule in the first place, and follow it consistently*. We discuss three possibilities.

One is the Taylor rule, which the U.S. Federal Reserve followed for the better part of the 1980s and 1990s, with good results. The Taylor rule raises interest rates when growth and inflation are high, and lowers them when growth and inflation are low. It can be summarized in a single equation, making it easy for central bankers to know how they are supposed to react to a given set of economic conditions.

The second possibility is nominal gross domestic product (NGDP) targeting. NGDP, also known as “current dollar GDP” or “chained dollar GDP,” is the

Gross Domestic Product figure before being adjusted for inflation. If the NGDP goes up by 5 percent, then so does the money supply, in lockstep. It attempts to keep each dollar describing the same amount of wealth, which should result in more stable, predictable prices.

Third is the Friedman rule, named for economics Nobel Prize winner Milton Friedman. Under the Friedman rule, the central bank deflates the currency at the same rate as the prevailing interest rate on government bonds. The goal is to make people indifferent about whether they keep money in their wallet or in a savings account. That means people will make allocation decisions based on economic efficiency, not the vagaries of inflation.

Central banks around the world have poor records of currency management. As a result, private alternatives, mostly in the form of digital currencies, are beginning to emerge. But in many countries these are hampered by a gray-area legal status or even bans. Governments should affirm private alternatives' legality—and legalize them where necessary. The general principle is to allow currencies to succeed or fail on their merits, depending on how well they serve people's needs. At this writing, bitcoin is the most popular private currency. While we doubt bitcoin's long-term viability because it is inherently deflationary, it has already done an enormous public service by popularizing the concept of digital currency and introducing blockchain technology to widespread use.

Open competition among digital currencies could help the poor by giving them honest currency they can use to start businesses, borrow and lend against, and invest. Many people cannot currently do these basic financial actions under centrally managed currency, owing to its uncertain long-term value and risks of devaluation, inflation, and other potential problems.

Removing obstacles to entrepreneurship is central to achieving certain goals to help the poor. These include

affordable energy, access to capital for entrepreneurs, occupational licensing reform, greater government transparency, and institutional-level changes to the regulatory process. Reforms to achieve these goals have the added bonus of helping to reduce opportunities for governmental corruption.

Affordable energy improves almost every aspect of people's lives, from cleaner home heating to more transportation options, which expands job opportunities and career choices. To the extent that governments hinder entrepreneurs' access to capital, they keep their citizens from achieving prosperity. Governments should get out of the way. Access to capital enables entrepreneurs to start a business, which is a way for people to escape poverty while creating even more value for others, enabling them to escape poverty as well, in a virtuous cycle.

Even in a relatively free economy such as the U.S., nearly a third of workers need a license to practice their chosen occupation. Despite the usual consumer protection rationales, the actual effect of much occupational licensing is to restrict competition, raise consumer prices, and keep willing workers unemployed.

Government corruption is a serious problem in many countries, and greater transparency and accountability could do much to lessen it. Transparency can take many forms, though we focus on regular mandated reports and disclosures about a government's regulatory policies. If an entrepreneur is uncertain about whether he has to bribe an official to get a permit, or does not know what regulations might be coming down the pipeline, it can have a chilling effect, which hurts him and his would-be customers.

We conclude by tying our reform agenda back into the need for poverty activists to focus on people, not ratios.

Introduction

What makes it possible for living standards for both rich and poor to rise over time? The right mix of institutions and public policies is very important: secure property rights, a strong rule of law, limited corruption, free trade, a reasonable regulatory system, currency stability, and so on. These have helped to make possible what economic historian Deirdre McCloskey calls “The Great Fact”—the massive improvement in living standards over the last two centuries.¹ Her capitalization is intentional. In terms of distancing humanity from its Hobbesian past, the Great Fact is a historical process on par with the invention of fire or the Agricultural Revolution. Throughout history, most human lives have been solitary, poor, nasty, brutish, and short. The Great Fact is that today, most people’s lives are interconnected, rich, kind, peaceful, and long. McCloskey puts the Great Fact in its proper context:

You, oh average participant in the British economy, go through at least sixteen times more food and clothing and housing and education in a day than an ancestor of yours did two or three centuries ago. Not sixteen percent more, but sixteen *multiplied* by the old standard of living. You in the American or South Korean economy, compared to the wretchedness of the former Smiths in 1653 or Kims in 1953, have done even better.²

Nothing like this had ever happened before in thousands of years of human history—and the process continues today. But how did the Great Fact begin to happen? Like much else in life, it started at the bottom, with the simple act of ordinary people talking to each other. Going forward, the most important task for the social sciences is to allow this bottom-up process to continue, so that the Great Fact can expand to more and more places until everyone on Earth has what they need to live with dignity, comfort, and freedom.

In the accompanying Competitive Enterprise Institute paper, “People Not Ratios: Why the Debate over Income Inequality Asks the Wrong Questions,” we argue that many inequality activists have been asking and answering the wrong questions in their quest to help the poor.³ Instead of analyzing the mathematical ratios between high and low incomes, poor people would be better served by an emphasis on raising their real-life living standards. The approach we suggest is threefold.

Focus on people, not ratios.

Instead of focusing on the mathematical ratio between a company CEO’s pay and its median or lowest-paid employee’s pay, focus on how lower-income people are actually faring over time.

1. Craft policies that effectively fight absolute poverty, rather

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A pro-business approach promotes policies that help specific businesses. Pro-market policies, on the other hand, focus on maintaining an open and fair competitive process, under which businesses can succeed or fail on their merits.

than relative poverty. Policies such as minimum wages and collective bargaining seek to reduce *relative* poverty—the difference between rich and poor. But because of trade-offs, they do nothing to solve *absolute* poverty, which is the real-life living standard of the worst-off.⁴

2. Raise the floor, rather than lower the ceiling. Bill Gates is the richest man on Earth, according to the latest Forbes 400 list, with a net worth of more than \$75 billion.⁵ Confiscating his entire estate would make possible a one-time gift of about \$11.00 to every person on Earth. That would not do anybody any good in the long run. Instead of tearing down success, it is better to make more success possible. Entrepreneurs make money by creating value for other people. The more successful more entrepreneurs can become, the better off everyone else is who benefits from their products and innovations.

This essay applies that three-pronged approach to a concrete policy agenda to raise living standards for the people around the world who need it most.

We begin by looking at two policies currently popular with many

anti-poverty activists: the minimum wage and expanded collective bargaining. We find that both policies are not only incapable of reducing absolute poverty; they are also ineffective at flattening the relative poverty their proponents hope to address. We then outline policies that are genuinely capable of lifting large numbers of people out of poverty.

Reducing absolute poverty requires adopting policies that respect some fundamental economic principles.

The first is economic freedom. Mass prosperity will never flourish without the necessary preconditions that make entrepreneurship, openness, and commerce possible.⁶ Policies that respect and bolster economic freedom are *pro-market*, rather than *pro-business*. The distinction is important. A pro-business approach promotes policies that help specific businesses, such as the General Motors and Wall Street bailouts. Pro-market policies, on the other hand, focus on maintaining an open and fair competitive process, under which businesses can succeed or fail on their merits. As such, a policy agenda to help the poor involves removing obstacles to entrepreneurship for as many people as possible.

The second principle is an honest price system. Rather than outline a single, one-size-fits-all monetary policy, central banks should adhere to clear rules that allow consumers,

entrepreneurs, and investors to know how the currencies in their pocket will behave in both good times and bad. Several possible rules are suited to the task. Private currencies also show promise in this regard. If private currencies turn out to be more honest than government-issued ones, then people would benefit from using them. Denying people that potential benefit—especially the poor who stand to benefit the most—is not conducive to making the world’s poor better off.

Affordable energy and access to capital are crucial for improving the lot of the world’s poorest people. Affordable energy enables clean home heating, easy transportation to work and school, Internet and telephone usage, and much more. Entrepreneurs need access to capital to start and grow businesses. This can range from being able to take out loans against one’s home to having access to microlending programs, all the way up to Initial Public Offerings for newly public corporations.

With these principles in mind, we also propose a regulatory reform agenda. Its planks include:

- Occupational licensing reform at the federal, state, and local levels;
- Congressional votes on all new major regulations;
- A regulatory “budget” similar to the government’s annual fiscal budget;

- Five-year sunset provisions for all new regulations, which can be renewed with a congressional vote;
- Timely issue of legally mandated government transparency reports;
- Additional transparency reports, such as annual report cards for every regulatory agency;
- Similar sunset provisions for regulatory agencies themselves; and
- An independent commission tasked with combing through the *Code of Federal Regulations* every year and sending Congress a package of old, obsolete, redundant, or harmful rules for an up-or-down vote.

These proposals are geared to the U.S., but the general principles behind them apply to many countries. We conclude by tying this reform agenda back into the need for a new approach to poverty reduction focused on people, not ratios.

The Minimum Wage

The minimum wage is one of the most popular policies aimed at reducing relative poverty. A March 2014 Pew poll found 73 percent support for raising the minimum wage to \$10.10 per hour.⁷ Lawrence Mishel, President of the union-allied Economic Policy Institute, argues that the “declining value of the

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minimum wage has played a key role in these trends” toward higher income inequality.⁸ President Obama, in his October 11, 2014 weekly radio address, said: “We believe that in America, nobody who works full time should ever have to raise a family in poverty. ... America deserves a raise right now.”⁹ When Seattle passed a \$15.00 per hour minimum wage in 2014, to be phased in over seven years, the City Council’s website proclaimed, “City Council Approves \$15/hour Minimum Wage in Seattle: Historic vote addresses income inequality.”¹⁰

The problem with setting a minimum wage is that it ignores tradeoffs. A minimum wage helps some workers, but at the price of hurting others. A Congressional Budget Office study of a proposed \$10.10 per hour minimum wage estimates: “[I]mplementing the \$10.10 option would reduce employment by roughly 500,000 workers in the second half of 2016, relative to what would happen under current law,” with a 1 million-worker unemployment increase well within the realm of possibility.¹¹ This results in a regressive income transfer and increased inequality. Some low-income workers get a raise precisely as other low-income workers see their hours cut, or even lose their jobs entirely. Other workers will never be hired in the first place.

Most economists agree that the minimum wage cannot achieve its

aim. Harvard economist Greg Mankiw’s “Ten things economists believe” is a list of statements that professional economists find uncontroversial. One of these, “A minimum wage increases unemployment among young and unskilled workers,” finds 79 percent support among economists.¹²

The overwhelming majority of empirical studies into the effects of the minimum wage find that it reduces employment. In 2007, economists David Neumark of the University of California-Irvine and William Wascher of the Federal Reserve surveyed over 100 minimum wage studies published since the early 1990s. They discovered that over two-thirds of them found negative effects on employment, while only about one eighth found positive effects. Worse, those studies that focused on low-skilled workers, including youths, found particularly bad damage done. Wascher and Irvine also looked at the quality of the studies. They found 33 studies that were robust to most criticisms, of which 28 found negative employment effects.¹³ A cardinal rule of public policy is that *intentions are not results*. Just because minimum wage advocates have good intentions does not mean their policies will have positive results in the real world. The following sections show some of those unintended, but foreseeable consequences.

Real-world examples of minimum wage damage. Different companies in

different situations will use different mixes of tradeoffs. But those tradeoffs will never go away. For example, on-the-job perks such as complimentary meals and parking become less common, and employers may be less inclined to offer other non-wage benefits such as generous leave policies or insurance. This has the unintended consequence of increasing taxes on some of the poor. Non-cash perks such as parking and food are not taxed, but when they are converted to wages, they become subject to income and sales taxes. So not only do workers have to pay for perks that used to be provided free of charge, they get taxed for them, too.

That is precisely what happened in SeaTac, Washington, after it implemented a \$15.00 per hour minimum wage in 2014. *Northwest Asian Weekly's* Assunta Ng interviewed two workers in SeaTac:

“Are you happy with the \$15 wage?” I asked the full-time cleaning lady.

“It sounds good, but it’s not good,” the woman said.

“Why?” I asked.

“I lost my 401(k), health insurance, paid holiday, and vacation,” she responded. “No more free food,” she added.

The hotel used to feed her. Now, she has to bring her own food.

Also, no overtime, she said. She

used to work extra hours and received overtime pay.

What else? I asked.

“I have to pay for parking,” she said.

I then asked the part-time waitress, who was part of the catering staff.

“Yes, I’ve got \$15 an hour, but all my tips are now much less,” she said. Before the new wage law was implemented, her hourly wage was \$7. But her tips added to more than \$15 an hour. Yes, she used to receive free food and parking. Now, she has to bring her own food and pay for parking.¹⁴

These consequences may have been unintended, but they are foreseeable—if a company’s labor costs go up, it will look for cuts elsewhere. These can come from non-wage compensation like parking, food, insurance, and other benefits. Employers can also cut employees’ hours or, if times are tough, lay off some employees. Employers will also become more reluctant to hire additional workers, particularly if they have low levels of skill and experience that might not add up to a \$15 per hour wage. Knowing that these tradeoffs exist, is a minimum wage increase worth its cost?

Annual bonuses are another possible casualty of high minimum wages. Workers at the Wetzel’s Pretzels store in Westfield Valley Fair Mall in

The minimum wage's least visible tradeoff is some workers never being hired in the first place.

California found this out the hard way.¹⁵ The mall straddles municipal borders, with one side of the mall in San Jose, and the other in Santa Clara. In 2012, San Jose passed a \$10 an hour minimum wage (now \$10.15), while Santa Clara stayed at \$8.00 an hour (since increased to \$9.00 an hour). Wetzel's Pretzels was unable to raise prices enough to cover increased labor costs because of a competing pretzel shop on the mall's cheaper Santa Clara side. Owner Yvonne Ryzak was reluctant to cut hours or staff.

Instead, she combined a slight price increase with lower profits. Ryzak has a policy of sharing 15 percent of her profits with employees in the form of an annual bonus. "Yvonne had to remind her employees the bonuses she pays are based on profits, profits which are smaller because she's already paying them more," reported National Public Radio's Steve Henn.¹⁶

Consumer prices can also go up with a sufficiently high minimum wage. MasterPark, which operates parking lots at Sea-Tac Airport, contemplated replacing some of its workers with automated kiosks, but instead added a 99-cent daily "living wage surcharge" to its fees. Out of Sea-Tac's 16 parking lot operators, it was one of only two that was subject to the \$15.00 per hour minimum wage, and had to recoup its costs somehow.¹⁷

Even the lower minimum wages prevailing in the rest of the country

are high enough to have visible tradeoffs. In the aftermath of the Great Recession, teenage unemployment spiked from 15.5 percent to 27.1 percent in December 2009. This is the highest figure the federal government has ever recorded, going back to 1948.¹⁸

The minimum wage's least visible tradeoff is some workers never being hired in the first place. The actual individuals never hired due to a minimum wage are impossible to identify, but the data indicate these willing would-be workers tend to be young and members of ethnic minority populations. Young workers typically have higher unemployment rates than older workers to begin with. This makes sense; younger people typically have fewer skills and less experience than their elders. And many young people are still in school or have young children, which limits their hours and availability. Minimum wages amplify this disparity by pricing some inexperienced and less skilled workers out of the market altogether.

Aspen Gorry of the University of California-Santa Cruz found that minimum wages "interact with a worker's ability to gain job experience." The most recent round of federal wage increases, which raised the minimum wage to \$7.25 per hour in steps from 2007-2009, raised the age 15-24 unemployment rate by 2.8 percentage points, more than triple the effect it had on older workers.¹⁹

Gorry also looked at youth unemployment in France, where the minimum wage is about \$12 per hour, considerably more than America's. The French youth unemployment rate has hovered around 24 percent, double the U.S. rate. Gorry finds that the different minimum wage levels account for nearly the entire difference between France's and America's youth jobless rates. That means France could find jobs for about half its unemployed youngsters by reducing its minimum wage to American levels.²⁰

Minimum wages hit minority youth even harder. In 1948, despite severe racial discrimination, African American 16-year olds had an unemployment rate one percentage point *lower* than their white counterparts. By 1974, after a series of faster-than-inflation minimum wage increases, the difference had grown to more than 20 points higher.²¹

High minimum wages also give big businesses an advantage over their smaller competitors. Whenever minimum wage increases become politically viable, big companies like Walmart often lobby for them. Walmart publicly favored the 2009 federal minimum wage increase to \$7.25 per hour.²² While it has been less supportive of many recent proposals to increase the minimum wage to anywhere from \$9.00 per hour to \$15.00 per hour, it has usually not opposed them, either.²³ There are exceptions, though. Walmart's recent experience with the District of

Columbia's government provides one recent example. When Walmart decided not to open two new D.C. stores, it cited the minimum wage. According to *The Washington Post*:

[D.C. City Council member Jack Evans] said the company cited the District's rising minimum wage, now at \$11.50 an hour and possibly going to \$15 an hour if a proposed ballot measure is successful in November. He also said a proposal for legislation requiring D.C. employers to pay into a fund for family and medical leave for employees, and another effort to require a minimum amount of hours for hourly workers were compounding costs and concerns for the retailer.²⁴

Even with parochial local political maneuvers becoming so common, large companies know that they can better afford to take on extra payroll and other expenses than the mom-and-pop store down the road.

This is true even when a large company is untouched by a minimum wage increase, as is typically the case with Walmart. Costco, which pays all of its employees well above minimum wage, would not be directly affected by most proposed minimum wage increases. But its smaller competitors would. Smaller firms would be disadvantaged by some combination of increased payroll,

Minimum Wages and Crime

There is some evidence that high minimum wage laws increase crime rates. People who become unemployed because of high minimum wages have to do something to get by. Some of them turn to criminal activity such as dealing drugs or selling stolen property.²⁷ Idle hands are also more likely to engage in non-monetary crime, such as vandalizing property and getting into fights.

One study based on National Longitudinal Survey of Youth data from 1997-2010 found, in states that increased their minimum wages during that time, that “crimes increase among minimum wage-bound workers and most strongly among teenagers, and that these increases occur among both monetary and non-monetary crimes. ... [A]ffected 14-16 year-olds are 8.4 percentage points more likely to commit crimes, and 17-19 year-olds increase crime by 3.4 to 4.1 percentage points.”²⁸ The criminal records these displaced workers compile harm their future job prospects, adding another reason to a long list of why high minimum wages make breaking out of poverty more difficult, and are an ineffective tool for reducing economic inequality

reduced hours for employees, fewer employees, fewer benefits, and other tradeoffs. This means higher prices and fewer employees to help customers, which drives more customers to Costco, Walmart, and other bigger companies.

Consumers are also subject to minimum wage tradeoffs. Businesses that use large numbers of minimum wage workers, such as fast food restaurants, tend to raise their prices the most following a minimum wage hike. A 2008 study by Daniel Aaronson and Eric French of the Chicago Fed and James MacDonald of the U.S. Department of Agriculture found that fast-food restaurants pass through 100 percent of the wage increase to their customers in higher prices.²⁵ Another study by Sara Lemos of the Institute for the Study of Labor found that a 10 percent increase in the minimum wage led to a 4 percent increase in food prices and an overall increase in prices of just over half a percentage point.²⁶

That may sound small, but consider where the effects fall hardest. Workers earning minimum wage are more likely to patronize fast food restaurants than anyone else, and food in general forms a much bigger part of their budgets. A significant part of the minimum wage increase is almost literally eaten up by higher food prices. The effect is all the more significant for those who

work at those restaurants and may no longer have access to complimentary shift meals.

Minimum wages give some workers a raise, but with a bleak litany of tradeoffs. Some workers get fired. Others have their hours cut. Some lose access to non-wage perks, including insurance, vacation days, and complimentary parking and meals, or see them severely reduced. Others receive lower annual bonuses. Some workers are never hired in the first place, and many see their purchasing power cut due to higher prices. Minimum wage increases are not just incapable of reducing absolute poverty, they are incapable of reducing the relative poverty that many minimum wage activists prioritize.

Collective Bargaining

A widely held view of labor unions is that they reduce economic inequality and help the least well-off by securing higher wages and benefits for their members. Union members do tend to earn higher wages and benefits than their non-union fellows in similar occupations, even when controlling for factors such as education, experience, credentials, and other work-relevant variables. But, as with the minimum wage, collective bargaining's benefits have tradeoffs. Its effects on reducing

economic inequality and raising living standards for the poor are questionable. This is because union members' higher wages and benefits come at a cost to others.²⁹ As it turns out, this is often by design.

A less idealistic view of labor unions is in order.³⁰ Union benefits come at others' expense. Just as corporations and public officials work to benefit themselves and not consumers or the public, unions work to benefit their own members, not all workers. The benefits unions accrue for themselves and their members come at a cost to everyone else. Collective bargaining does not create *new* wealth. It merely transfers *existing* wealth away from consumers and non-union workers—and in the case of government unions, away from taxpayers—toward unions and their members.

When unions are successful, their members' artificially high compensation causes a deadweight loss for other people. The higher prices of union-made goods leaves less money left over for consumers to spend on other things. Collective bargaining, far from alleviating poverty, suppresses income.

In a study published by the Competitive Enterprise Institute, Ohio University economist Lowell Gallaway and researcher Jonathan Robe find: "Over a period of 50 years, the cumulative reduction in worker wages would be about 15 percent. ... [S]mall annual effects produce a substantial cumulative

loss of GDP—as much as a 10 to 12 percentage point loss over a century."³¹ The impact varies from state to state, based on the presence of right-to-work laws and other labor and employment policies.

Gallaway and Robe calculated the deadweight loss cost of collective bargaining on all 50 states and the District of Columbia. They found that in the worst affected state, Michigan, the cost of collective bargaining since 1964 was to depress median real per capita income in 2011 by over \$11,000 per head—a 23 percent of median income from \$48,000 to just over \$37,000. New York State's loss was over \$12,500 in real income, although this was less in percentage terms than that of Michigan's. California's loss was over \$9,000. The presence of right to work laws alleviated this effect in many states. The least affected state, South Carolina, which has a right-to-work law, suffered a loss of only 3.5 percent.³²

Union actions are typically geared toward increasing their number of dues-paying members. As noted, the benefits union members receive come at others' expense, often through job opportunities denied to non-union workers because companies cannot afford to hire as many employees at a union wage rates. As with the minimum wage, collective bargaining creates a regressive income transfer from poor non-union members to less poor union

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members. This increases income inequality and impedes the wealth creation necessary to reduce absolute poverty.

Government employee unions' burden on taxpayers. Unions that represent government employees at the federal, state, and local levels are even more problematic. Many private sector companies can relocate to escape unionization. Governments do not have that option. Governments also have less of an incentive to keep labor costs under control. As a result, in the U.S., more than 35 percent of government workers are union members, compared to less than 7 percent in the private sector.³³

Compulsory unionization and public sector collective bargaining are relatively recent phenomena that were virtually unknown in the early days of the American labor movement—for good reason.

Samuel Gompers, the first and long-time leader of the American Federation of Labor, said in 1918: “There may be here and there a worker who for certain reasons unexplainable to us does not join a union of labor. That is his right, no matter how morally wrong he may be. It is his legal right, and no one can dare question his exercise of that legal right.”³⁴

President Franklin D. Roosevelt, whose administration introduced legally

enforced collective bargaining, in 1937 wrote: “All government employees should realize that the process of collective bargaining, as usually understood, cannot be transplanted into the public service.”³⁵ And in 1955, AFL-CIO President George Meany said: “It is impossible to bargain collectively with the government.”³⁶

It was precisely for these reasons that government employees were deliberately excluded from the National Labor Relations Act of 1935, also known as the Wagner Act, after its sponsor, Democratic New York Senator Robert F. Wagner. That held until 1958, when New York Mayor Robert Wagner (Senator Wagner’s son) allowed city officials to unionize in an effort to secure his reelection. His Executive Order 49, known as “the little Wagner Act,” allowed city employees to unionize and made unions the exclusive bargaining representatives for city employees.³⁷

In Wisconsin, where the American Federation of State, County, and Municipal Employees (AFSCME) was founded in the 1930s, public employees were able to unionize and collectively bargain after Democrats swept the 1958 elections in the state.³⁸ The federal government followed suit in 1962, when President John F. Kennedy issued Executive Order 10988 to allow federal employees to organize and to bargain collectively, except over wages, which remained under Congress’ control.³⁹

The truth is that unions as currently organized cannot flourish without some element of outside force supporting them. A natural test of this arose recently in Wisconsin. For many years, Wisconsin state law allowed public sector unions to automatically deduct dues from government workers' paychecks to pay for union representation, even for non-union workers who did not want it. That changed with the passage of Act 10, the contentious 2011 state budget repair bill, which ended automatic paycheck deductions of union dues and gave most government workers a choice of whether to join a union or not. Act 10 also gave workers the power to hold unions accountable by being able to vote annually on whether to recertify their union or not—an existential threat to unions that do a poor job serving their members.

What are the results of this experiment in voluntary unionism? The Wisconsin State Employees' Union saw a 60 percent membership decline by early 2014. The city government of Oshkosh, with 560 employees, saw union membership drop from 450 to 225. In a painful bit of irony, the very first AFSCME local, founded in 1932 in Madison, saw its membership decline from 1,000 to 122 after Act 10.⁴⁰

For unions, it is rational to advocate for strong collective bargaining laws, because it means more dues-paying

members—as well as dues from non-members, who are forced to pay “agency fees” for union representation in collective bargaining. Union officials claim they need to charge such fees because the union has to represent all employees in a given workplace. But there is no legal requirement for the union to represent non-members. Unions could let individual employees opt out of collective bargaining contracts, but choose not to do so. The bottom line is that forcing workers to pay unwanted dues for unwanted representation does nothing to reduce poverty or economic inequality.

Government unions' ill effects on education. Government employee unions undermine opportunity for people to rise out of poverty by lowering the quality of education through rigid union rules and seniority-based compensation. Better education is critical to poverty alleviation. For better education, society needs better teachers. Yet union-negotiated compensation packages reward teachers who have been in the job longest, and it is these teachers who are most likely to have “burned out,” while younger, more enthusiastic teachers are more likely to be forced out of the profession when school boards need to cut staff.

A 2010 *Los Angeles Times* investigation found that the impoverished Westlake neighborhood had suffered thanks to

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teachers' union demands. Thanks to seniority rules approved by the union, budget cuts led to the firing of the school district's most effective teachers:

- 190 teachers ranked in the top fifth for math and English teaching were laid off, and more than 400 ranked in the top 40 percent.
- Almost one in 10 teachers in poor South Los Angeles were laid off, double the rate of other areas.
- Sixteen schools, almost all in South or Central Los Angeles, lost at least a quarter of their staff.
- Because the least experienced teachers earned less, about 25 percent more teachers had to be laid off to meet budget requirements than would have been the case if the staff cuts had been made on performance criteria.⁴¹

Most of those laid off were union members. When they asked the union for help, they were told that seniority-based layoffs were union policy and that to make exceptions would be an "act of disloyalty."⁴²

Government employee unions, including teachers' unions, jealously defend the status quo, and fiercely oppose attempts at reform. When then-New York City Public Schools Chancellor Joel Klein attempted to reform the city's teacher

pension system in the mid-2000s, the teachers union shut down his effort. Klein described the situation in *The Wall Street Journal*:

[T]hese pension systems make the total compensation package much too back-loaded: Pay in the early years is needlessly low, so we lose good people who don't find the generous benefits at the end worth the lifetime commitment. ... A mix that was more typical of what exists in the private sector would help us attract more qualified people into teaching—and keep them there during the first five years, when we traditionally lose a third or more.⁴³

Klein attempted to introduce a new pay structure based on discussions with new and prospective teachers. It would give a newly hired teacher a choice between the prevailing system and one that was frontloaded and with a higher salary and lower pension benefits. Even though the choice would be left entirely to the new hires, the offer was rejected on the grounds that it was "anti-union."⁴⁴

Compulsory unionization and collective bargaining reduce economic opportunities for those who need them most in other ways. Whether one's goal is absolute or relative poverty reduction, expanded collective bargaining is ill-suited to the task.

Policies to Help the Poor

A policy agenda to end absolute poverty must focus on reducing artificial barriers to wealth creation. It should be comprised of policies that are *pro-market*, rather than *pro-business*. The distinction is important, because both critics and defenders of free markets often confuse the two. Pro-business policies that use government intervention to help specific businesses are an explicit rejection of free markets. Examples of such policies include the U.S. government's bailouts of car companies such as Chrysler and General Motors, the numerous bank bailouts in the wake of the 2008 financial crisis, government subsidies to fossil fuel and renewable energy companies, vast swaths of the 70,000-page federal tax code, and the very missions of government agencies such as the Economic Development Administration,⁴⁵ Small Business Administration,⁴⁶ Export-Import Bank,⁴⁷ and Overseas Private Investment Corporation, among others.⁴⁸ Overall, the federal government's corporate welfare expenditures total around \$100 billion per year.⁴⁹

Free-market advocates and many of their critics both oppose pro-business policies. Trouble is, both sides seem mostly unaware of their agreement on this point. Corporate welfare policies increase income ratios between rich and poor, insulate politically connected incumbent firms from upstart

competitors, and divert scarce resources toward Washington and away from serving customers better. In fact, lobbying has been a boom industry during the George W. Bush and Barack Obama presidencies, growing from \$1.57 billion in 2000 to \$3.24 billion in 2013. The number of active, registered lobbyists in Washington has exceeded 12,000 every year from 2002-2013, dropping to 11,818 in 2014.⁵⁰ Pro-business policies make absolute poverty eradication more difficult.

Pro-market policies are much more effective at reducing poverty. Rather than seeking to help individual businesses, they focus on maintaining an open and fair competitive process, within which companies succeed or fail based on how well they create value for people. Consumers, not politicians, have the final say under pro-market policies. Unlike pro-business policies that turn government into a player on the field, pro-market policies assign to government the role of an impartial referee, whose job is to see to it that the players on the field understand the rules, play by them, and know that they will be fairly and consistently enforced.

Honest Prices

An economy cannot function effectively without an honest price system.⁵¹

Pro-business policies that use government intervention to help specific businesses are an explicit rejection of free markets.

*Every person
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Despite some missteps by the Federal Reserve,⁵² the United States has a relatively honest price system, as do most other developed countries.⁵³

Keeping it that way is vital to the nation's economic health, and to the poor's well-being. As Johns Hopkins University economists Steve Hanke and Nicholas Krus argue, lack of currency honesty condemns countries to prolonged stagnation—witness Zimbabwe and Venezuela.⁵⁴

Honest prices benefit the poor. Prices distill complicated and diffuse information into a single, easy-to-understand number. In a way that nothing else can, prices guide people's actions in ways that make them better off, even if they know nothing beyond the number on the price tag. Prices direct people to economize their resource usage as much as they can, which keeps consumer goods as cheap as possible, and to find more affordable substitutes through innovation.

Every person in the world makes countless decisions every day based on prices. To illustrate, Nobel-winning economist F.A. Hayek gave the example of a tin mine that suffers a collapse and shuts down production.⁵⁵ This sudden tin scarcity shoots prices through the roof. Seeing the higher price, tin users throughout the economy, from manufacturers to canned food producers, know to be more careful with their tin supplies, and will seek out less costly

substitutes. They do this even if they had never heard about the shuttered mine; the price of tin tells them all they need to know.

However, if money prices are artificially distorted by unexpected inflation, deflation, or other political factors, people will make different decisions than they would otherwise. The result is malinvestments—investments that would never have been made under an honest price system. Dishonest prices result in greater economic volatility and lower overall growth, and deny higher living standards to the poor over the long run.

The 2008 financial crisis provides a textbook example of how government-created price distortions hurt poor people. In the United States, federal policies intended to increase home ownership—from making mortgage interest payments tax-deductible to loosened lending standards—led to more and more money going into artificially cheap housing, leaving less capital left over for other investments. Moreover, the Fed's excessive lowering of interest rates sent distorted signals about time preference and the scarcity of capital that influenced people's decision making toward malinvestment. The result was a housing bubble that eventually popped, setting off the 2008 financial crisis and the longest, most severe recession since the Great Depression.⁵⁶ Millions

of homeowners suddenly found themselves “underwater,” meaning they owed more on their mortgages than their homes were worth, leaving them no choice but to foreclose. And because the housing bubble left less capital available for other parts of the economy, recovery has been slower than necessary.

Central Banks Need to Follow Rules

There are many ways to keep a country’s price system honest. For countries with central banks managing their currency, one key is for those central banks to behave predictably. One of many ways central banks can achieve this is by following a certain rule. There is a fair amount of flexibility regarding what that rule can be, but so long as it is geared toward price honesty, it will suffice. This section will briefly introduce three candidates.

First is the Taylor rule, named after Stanford University economist John B. Taylor. The Taylor rule adjusts the Fed’s overnight interest rate countercyclically. Its central equation incorporates inflation and GDP growth.⁵⁷ Under the Taylor rule, high inflation will automatically cause the Fed to raise interest rates, bringing inflation back down to Earth. And if GDP growth is far above trend, representing possible economic overheating, the interest rate

will automatically rise to cool things off. Weak GDP growth induces lower interest rates, which can help the economy heat back up to its usual level.

Predictability makes long-term planning possible. Taylor’s point is not so much what the specific coefficients should be in the equation, but that the Fed *must follow a predictable rule*.⁵⁸ What matters is that whatever rule the central bank chooses is followed no matter what, in good times and in bad, even under heavy political pressure. The Fed followed something close to a predictable Taylor rule for nearly two decades, covering most of Paul Volcker’s Fed chairmanship and roughly the first half of Alan Greenspan’s. This period saw one of the fastest living standard increases in U.S. history.

A second possible rule is nominal gross domestic product (NGDP) targeting, as advocated by economist Scott Sumner.⁵⁹ Instead of the Fed manipulating interest rates as under a Taylor rule, the Fed focuses on the money supply. Specifically, it indexes the money supply to changes in NGDP, so the two move in lockstep. If NGDP goes up 5 percent in a year, so does the money supply. The result would be near-zero monetary inflation, at least in the short run. Nearly all price changes would be due to non-monetary factors such as changes in supply and demand, productivity increases, or changes in

Predictability makes long-term planning possible.

When it comes to central bank behavior, honesty is absolutely essential.

the basket of typical goods in a given country. This would do much to keep prices as honest as possible.

A central bank could also maintain a constant, say, 2 percent annual inflation by increasing the money supply two percentage points beyond NGDP growth. While we would prefer as close to zero monetary inflation as possible, this option might make a predictable monetary policy rule such as NGDP more appealing to inflation doves. As a second-best, one could do much worse.

A third possible rule is the Friedman rule, named after economics Nobel laureate Milton Friedman.⁶⁰ It is actually mildly deflationary. The Friedman rule would deflate the money supply at the same rate as the nominal interest rate on government bonds and similarly yielding investments, resulting in a real interest rate of zero. A slow, predictable deflation makes pocket money gain value over time in a way that exactly offsets the interest paid on government bonds and similar assets. The goal is to make people completely indifferent as to whether they hold their money in their pockets or put it into a savings account. This indifference means that economic efficiency, rather than inflation, becomes the deciding factor in where people keep their money. This leads to more efficient economic decision making, maximizes economic growth,

and raises living standards over the long run.

Each of these three rules has advantages and drawbacks, and critics and supporters. And there are many other possible monetary rules worthy of consideration. Our point is not so much which rule a central bank should adopt, but that *it must have a rule in the first place and follow it consistently*. This gives people predictability by keeping prices throughout the economy honest. If entrepreneurs know in advance that central banks will not freak out and change course during a crisis, it is much easier for them to make long-term plans, avoid malinvestments, and raise living standards. When it comes to central bank behavior, honesty is absolutely essential.

Discipline from Competing Currencies

There is one other force that can keep prices honest: competition. Competition can take many forms. Politically, the easiest would be for a government to give the same legal tender status to foreign currencies it gives its own. Consumers and investors would choose to use the most honest currencies, and shun volatile or dishonest ones. This competition, especially if allowed by multiple countries, would give governments a powerful incentive to

restrain their inflationary impulses and make prices more honest.

There is no iron law that only governments can issue currency.⁶¹

The only requirement for something to function as a currency is that people accept it as a means of exchange. Items as diverse as gold, paper, cigarettes, and cowrie shells have all worked as functional currencies in different times and places.⁶² Portability, divisibility, resistance to counterfeiting, and other desirable attributes are all important, but they are secondary to people actually accepting a currency.

Today, privately created digital currencies such as bitcoin are starting to emerge. Some are more popular than others, and each one has different built-in rules. The total number of bitcoins, for example, is set at a maximum of 21 million. This makes bitcoin inflation-proof, which is one reason for its popularity. But this hard limit also makes it subject to long-term deflation as both population and per-capita wealth increase over time.

Fortunately, so long as competition is legal, that will not be a problem. If bitcoin fails to prove useful or popular over time, other digital currencies could emerge with algorithms modeled instead after a Taylor rule, an NGDP targeting rule, a Friedman rule, or any other rule. The possibilities are endless.

Germany's government has legally recognized bitcoin as private—and

thus taxable—money.⁶³ By contrast, Ecuador's government has banned bitcoin and created its own digital currency.⁶⁴ Ecuador's ban on competition is an implicit admission of weakness. If Ecuador's government has confidence in its product, it has no need to ban competitors.

There is no single correct monetary policy. But sound monetary policy must always incorporate the bedrock principle of honesty. Fair and open competition among both government and private currencies will give people access to honest currency, no matter where they live. Whichever currency people trust the most will eventually emerge on top—so long as governments allow the competitive discovery procedure to operate.

Affordable Energy for Everyone

Affordable energy is fundamental to what economist Deirdre McCloskey calls the “Great Fact” of the explosion of human welfare.⁶⁵ It remains central to the reduction of absolute poverty. Yet, some Western governments seek to increase energy costs, purportedly to combat global warming. What they are actually combating is the poor's prospects for a better life.

President Obama said during his first election campaign that electricity rates from coal would “necessarily skyrocket” under his policies. That

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U.S. energy markets show that innovation beats regulation every time when it comes to human betterment.

may come to pass under the Environmental Protection Agency's proposed Clean Power Plan, if the courts allow it to proceed.

Despite the president's policies, U.S. energy markets show that innovation beats regulation every time when it comes to human betterment. Even though huge swaths of American energy resources are locked up under untouchable federal lands, energy production has boomed over the past decade, thanks to the development of horizontal drilling and improved hydraulic fracturing techniques. These technological advances have led to lower electricity prices from natural gas. Subsurface property rights have benefited both urban and rural households through royalty payments for energy production on their land.

Moreover, as gas became more affordable, it led to a reduction in greenhouse gas emissions. Indeed, thanks to energy innovation, America met the emissions targets set for it in the Kyoto Protocol, without any need for burdensome laws and regulation—or the Kyoto Protocol itself.⁶⁶ Whatever one may think of the need for carbon emissions reduction, energy innovation is achieving that goal.

This is all to the good, but more energy innovation is possible. The key is greater liberalization. America's government should free up federal lands to energy development, rather

than pickle them in regulatory aspics. Europe could enjoy its own energy boom by approving hydraulic fracturing.

The term “fuel poverty” describes households in cold climates that are not able to keep their home warm at an affordable cost. The primary causes of fuel poverty are low income, poor insulation, and high energy prices. In Europe, energy costs have increased due to a combination of renewable energy subsidies and mandates, bans or moratoria on hydraulic fracturing (“fracking”), hostility to nuclear energy, and Russia's control of natural gas supplies for much of the continent's eastern half.⁶⁷ As a result, 8 percent of households in Belgium, France, Spain, Italy, and the United Kingdom suffer from some form of fuel poverty, according to European Union data.⁶⁸ In the UK, where there is much more data owing to an official designation of fuel poverty, a household is defined as fuel poor if it has to spend 10 percent of its income on essential energy services; 10 percent of households meet this definition.⁶⁹

In both America and Europe, energy takes up a much larger share of poor households' budgets compared to other income brackets. For instance, a household with an annual income between \$10,000 and \$25,000 spends well over 10 percent of its budget on energy, according to the Bureau of Labor Statistics.⁷⁰ And a January 2014 study for the American Coalition for

Clean Coal Electricity found that “households earning \$50,000 or less spend more on energy than on food, spend twice as much on energy as on health care, and spend more than twice as much on energy as on clothing.”⁷¹

Increasing the cost of energy also harms people’s health, because energy use is so fundamental to modern life that it can take precedence over other household expenses—including health care. The National Energy Assistance Directors’ Association found that an increase in energy costs led 30 percent of poor households to reduce food purchases, 40 percent to go without medical care, and 33 percent to not fill a prescription.⁷²

Environmentalists surely rose when Greek air pollution levels decreased by 40 percent from 2008 levels thanks to the country’s severe economic crisis. Fewer people were using their cars or trucks, and, as a result, levels of sulfur dioxide and nitrogen oxides in the air had plummeted.

But those gains have been reduced and then some. In fact, Greece recently has seen a massive increase in smog, which reminds us that it is poverty that truly drives environmental damage. Smog has been a particular problem in major cities such as Athens and Thessaloniki, though high smog levels have been reported all over Greece—including the Peloponnese and Attica. Yet this is

not the sort of smog we worry about in American cities. It is an older, cruder form that is almost forgotten here. Reminiscent of the days of London’s “pea-soupers,” the Greek smog is a result of the increased burning of wood as household fuel. It has massively increased levels of pollutants. The average level of particulate matter in London fell from around 160 micrograms per cubic meter to less than 20 between 1961 and 1998, so successful was the industrialized West at cleaning up its act.

In early 2013, at the height of the Greek debt crisis, smog levels in Greece reached 300 micrograms per cubic meter.⁷³ Such dangerous levels can have substantial and damaging health effects. A London “black fog” in 1952 killed 4,000 people. Recent Greek smog levels approached that level of danger. Moreover, the effects of such lasting smog would be borne more by the poorest. As Greek commentator Nikos Konstandaras describes the smog:

This new plague appears to be democratic, spreading out all over Athens’s coastal basin, over the center and suburbs, over rich and poor, over young and old, natives and immigrants. ... But the veneer of universality is thin—again it is the poor who suffer most: They live on lower floors, where the toxins congregate, they are forced to burn whatever they find, huddling around open fires and

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buckets of embers. They will not be able to send vulnerable family members to the countryside.⁷⁴

Not only is the smog destructive of the atmosphere, it is destructive of forests. Greeks were forced by the high prices of home heating oil—of which a large proportion is taken up by taxes—to use wood for fuel, and much of that wood is gathered illegally. The Greek environment ministry estimates more than 13,000 tons of wood were harvested illegally in 2012.⁷⁵

Reducing artificially high energy costs is the first step in tackling fuel poverty. In America, the market is alleviating the burden of energy costs on poor households, even as the government goes the wrong way. That shows us the way forward for tackling the much greater problem in the developing world.

Wealthier is healthier when it comes to the environment, as well as people. That is exactly what we saw in the decreases in smog levels in the west over the last century. Yet, Greece regressed during its crisis (which is by no means over). As it becomes poorer, its environment suffers more. What happened in Greece was a retreat back up the slope of what is known as the Environmental Kuznets curve.⁷⁶ This model theorizes that, as a civilization starts to use natural resources, it increases its impact on the environment until it reaches a stage where it becomes

more efficient to reduce its impact. This is why the richest societies are generally also the cleanest.

The Greek financial crisis has been a disaster in many more ways than first thought. Two particular factors have combined here. First, the Greek state's massive overspending could not be corrected by devaluation; Greece is part of the euro zone, and cannot devalue the euro, despite its best efforts. This has led only to a massive wealth contraction within Greece, so people do not have as much to spend on fuel. Second, the Greek government's austerity program has relied heavily on raising taxes on energy—especially home heating fuel and electricity. The result has been increased reliance on wood and potential environmental disaster.

Prosperity makes life better, and not just for humans. If you ever needed an illustration of why affordable energy is important for the environment, Greece's recent history provides it. Poverty, on the other hand, is one of the environment's worst enemies.

Access to Capital

For most of human history, access to capital was limited to those who already possessed it in the form of assets or savings. With the dawn of modern finance, capital owners could begin to share their capital with others to mutual

benefit by means of loans. People pooling their savings and lending out to others to buy homes or start businesses increases the capital base, making everyone involved wealthier. Of course, none of this is without risk to the original providers of capital, nor is access to capital a guarantee of success. But all else being equal, the greater the accessible capital base, the wealthier those who have access to it will become.

However, since the financial crisis, capital has become less accessible. Many traditional forms of credit have dried up. Despite near-zero interest rates in much of the developed world, banks have severely cut back on making the sorts of speculative loans that started so many businesses in the last century.⁷⁷ Mortgage and credit card issuances have been severely restricted by new regulations from the Consumer Financial Protection Bureau (CFPB), as well as similar bodies in other countries.

The drying up of access to capital is largely a result of overregulation. Therefore, it is clear that deregulation would improve matters. In particular, we recommend three approaches:

- **Liberalize the chartering of new banks.** Studies have shown that de novo banks are more likely to lend to small businesses and startups.⁷⁸ Only two new banks have been founded since the financial

crisis. Congress should put in place new systems to allow for more new banks to be established more quickly by a wider variety of owners.⁷⁹

- **Impose greater accountability on financial regulators.** This should apply to agencies such as the CFPB, which has been insulated from accountability to elected officials because it is funded by the Federal Reserve, not Congressional appropriations. Greater accountability will make it less likely to fall under the control of bureaucrats who believe that poor people cannot make rational decisions about their own financial needs, and therefore need to have their choices restricted. The Federal Reserve also has banking regulatory powers for which it is unaccountable, owing to its role as an independent central bank. Greater accountability is needed in other countries as well.⁸⁰
- **End the Federal Reserve's and other central banks' zero interest rate policy.** This has led to malinvestments in already existing large firms listed on the stock market rather than bank deposit savings, which can in turn be used to provide access to capital via loans. In many cases, capital requirements have led to banks unnecessarily holding on

Entrepreneurs are finding new ways to share capital between investors and those who need it.

to funds that could have been invested instead.⁸¹

Each of these policies could inject additional liquidity into the lending system. Entrepreneurs, however, are finding new ways to share capital between investors and those who need it. In particular, two new forms of access to capital known as “fintech” (for financial technology) have developed in recent years:

- **Crowdfunding.** This form of financing allows individuals with good ideas or talents to find multiple backers willing to support their projects. Various online platforms have developed different models of funding. Patreon, for example, allows patronage of an individual by many small-dollar donors. Indiegogo specializes in backing a project in return for a system of reward tiers—the greater the donation, the bigger the reward. Kickstarter specializes in funding projects via a preorder model, where those who fund the development of a product are the first to receive it when it comes to market, usually at a discounted price, or with special perks. Equity crowdfunding allows companies to offer real equity investments with the benefits of ownership. This model has been restricted by

securities laws in the United States and other developed countries, but recent deregulation has led to the emergence of a market.⁸²

- **Peer-to-Peer Lending.** This innovative form of financing matches investors directly with people willing to take a risk in lending to them. Companies such as Prosper and Lending Club match investors with people who want to start a business, take out a loan for home repair, or pay off debts, at an interest rate comparable with their risk. In the U.S., the development of peer-to-peer lending services has been significantly hindered by securities laws (other countries, including the UK, are less restrictive). Deregulation to facilitate peer-to-peer lending could significantly increase the size of this market and remove the necessity for banks as a financial intermediary.

Regulators should allow these fintech markets to develop naturally, just as the banking system evolved over time. Doing so would increase the number of people able to access capital, and help alleviate poverty significantly.

Another form of access to credit is currently in danger of being regulated out of existence. Small-dollar loans,

including payday and car title loans, are vital to those on the margins of the banking system, including people facing short-term financial emergencies. For example, a small loan can mean keeping the lights on, especially when the electric company's fee for turning them back on is more than the interest on the loan.

Interest charges on these short-term loans seem very high as an annual percentage rate. For that reason, regulators and self-styled consumer advocates are trying to restrict them. But these kinds of loans are short-term by definition, so it makes no sense to gauge their cost based on an annual rate. Moreover, the high interest rates reflect the risk of lending to individuals with little credit history and limited access to the financial system.

In all probability, loan providers will respond to heavy-handed regulation by restricting loans to poorer individuals—making credit once again reserved for those who need it the least.⁸³ This is regressive. The likely effects will be greater inconvenience and reduced access to needed credit for consumers, leading to a possible resurgence of illegal lending, such as loan sharking. Prohibition comes with predictable unintended consequences.⁸⁴

This is particularly rich coming from government, which often assesses fines and fees on civil penalties that far outweigh the value of the original fine.

This can result in people stopped for a busted tail light owing thousands of dollars and even going to jail, simply on the basis that they were fined when poor.⁸⁵ Some jails have become essentially new debtors' prisons, and small dollar loans may be exactly what the debtor needs to escape such unjust prison time. As a policy to help the poor, restricting administrative charges on fines should be the top of the list for every local government.

Regulatory Reform

The United States has a relatively free and open economy, and is wealthy as a result. But there is room for improvement. For example, according to the Canada-based Fraser Institute's annual *Economic Freedom of the World Report*, published in collaboration with more than 30 think tanks around the world: "Throughout most of the period from 1980 to 2000, the United States ranked as the world's third-freest economy, behind Hong Kong and Singapore."⁸⁶ After more than a decade under the Bush and Obama administrations, the U.S. ranking fell from third to 12th in 2012, according to the Fraser index.⁸⁷ This is an improvement from 2011, when the U.S. ranked 17th.

Economic freedom is crucial for prosperity. After comparing 152 different countries on 42 different

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variables, *Economic Freedom of the World* authors James Gwartney, Robert Lawson, and Joshua Hall conclude:

“Nations in the top quartile of economic freedom had an average per-capita GDP of \$39,899 in 2012, compared to \$6,253 for bottom quartile nations (PPP constant 2011 US\$)[.]”⁸⁸ The difference is more than a factor of six. The implications for living standards for people at a country’s economic bottom are obvious.

The Heritage Foundation and *The Wall Street Journal* publish a similar annual index, using different methodology but reaching similar conclusions. The United States fell from the world’s sixth freest economy in 2001 to 11th in the 2016 edition. According to this index, America’s absolute score had remained virtually unchanged since the turn of the century, from 76.4—out of 100, with a higher score indicating greater economic freedom—in 2000 to 75.4 in 2016. This relative decline in ranking for the U.S. may indicate that much of the rest of the world is liberalizing, which is good news for the poor—in other countries. For U.S. policy makers, on the other hand, it underscores the need for economic liberalization.⁸⁹

In many developed countries, the biggest obstacle to entrepreneurship and wealth creation is the regulatory state.⁹⁰ John W. Dawson and John J. Seater estimate that in the United States, “annual output by 2005 is about

28 percent of what it would have been had regulation remained at its 1949 level.”⁹¹ Or, to put it more plainly:

In 2011, nominal GDP [in the United States] was \$15.1 trillion. Had regulation remained at its 1949 level, current GDP would have been about \$53.9 trillion, an increase of \$38.8 trillion. With about 140 million households and 300 million people, an annual loss of \$38.8 trillion converts to about \$277,100 per household and \$129,300 per person.⁹²

If Dawson and Seater’s estimates are in the right ballpark, the average American should be more than three times as wealthy as she actually is, but bad public policies have made her more than two-thirds poorer than she would be otherwise. Imagine what this means for the poor. In 2013, the U.S. Department of Health and Human Services calculated the poverty line for a family of four at \$23,550 per year.⁹³ That means that families living near the poverty line today could instead be earning around \$70,000 per year—a huge difference in standard of living. Worldwide, regulatory reform could have an even larger impact on people’s living standards.⁹⁴

Many people blame economic troubles on a *lack* of regulation. Nobel laureate economist and *New York Times* columnist Paul Krugman blames the 2008 financial crisis on deregulation,

which “in effect gave the industry— whose deposits were federally insured— a license to gamble with taxpayers’ money, at best, or simply to loot it, at worst.”⁹⁵ *Time* magazine includes former president Bill Clinton as one of 25 people to blame for the financial crisis, citing several instances under his watch of “financial deregulation, which in many ways set the stage for the excesses of recent years.”⁹⁶ Clinton himself also blames the financial crisis on a lack of regulation in his 2011 book *Back to Work*, arguing that “there was not enough government oversight or restraint on excessive leverage.”⁹⁷ Similar arguments have been made for every economic downturn since at least the Great Depression.⁹⁸

This popular misconception of an unregulated, Wild West economy does not stand up to scrutiny. All federal regulations are published in the *Code of Federal Regulations* (CFR). If you order a copy, the Government Printing Office will mail you 237 volumes.⁹⁹ At the end of 2015, these volumes total 178,277 pages, including a 1,170-page index.¹⁰⁰ Those pages contain more than 1 million specific regulatory restrictions,¹⁰¹ covering everything from the size of holes in Swiss cheese¹⁰² to proper procedures for weighing farm animals¹⁰³ to raising times for drawbridges.¹⁰⁴

That is just the stock of *existing* regulations. There is also a continuous flow of *new* regulations. Since President

George W. Bush took office in 2001, the CFR has grown by an average of 2,632 pages per year.¹⁰⁵ For the financial industry, the CFR had 26,235 separate regulatory restrictions in place in 2008 on the eve of the financial crisis, with 2,813 net restrictions having been added since 1997. An additional 2,448 financial regulations were published by 2012.¹⁰⁶

All new proposed and final regulations are supposed to be published in the daily *Federal Register*, along with agency notices and presidential documents. The *Federal Register* has exceeded 70,000 pages in 13 of the last 14 years, and topped 80,000 pages in 2010, 2011, and 2015.¹⁰⁷ Over the 20-year period 1993-2015, the *Federal Register* published nearly 1.67 million pages.¹⁰⁸ This is the opposite of deregulation. Yet, when the next economic downturn hits, many pundits and politicians will continue to blame deregulation while holding a straight face.

New regulations typically do not become final until a public comment period expires and the rulemaking agency publishes a revised final rule accounting for those comments. But some agencies evade this legal requirement. This means the numbers published in the *Federal Register* understate the regulatory state’s true size and cost. A controversial example of this evasion is the Transportation Security Administration’s

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Many countries' regulatory regimes are so bad that it is practically impossible to do business legally.

implementation of full-body scanners at airports across the country, which people were required to use or face a full, intrusive pat-down. This is a new rule governing travel by anyone's reckoning—except the federal government's. The scanners' adoption was never subjected to public comment. No rule outlining specific policies or scanner specifications ever appeared until the Competitive Enterprise Institute and some other organizations filed a lawsuit.¹⁰⁹

How much does all this regulation cost? It is impossible to say for sure, because so much of the cost of regulation is in the form of lost opportunity. What could have been, but never was because it was against the rules is impossible to quantify. But good ballpark estimates exist for regulations' more measurable costs. According to these, the federal regulatory state's total annual cost ranges from \$1.88 trillion¹¹⁰ to \$2.028 trillion.¹¹¹ There is an old joke about the decimal points in these kinds of numbers being evidence that economists do, in fact, have a sense of humor. Take the last couple of significant digits as seriously as they deserve, but their larger predecessors make a serious point. By way of comparison, Canada's entire 2013 GDP was \$1.827 trillion.¹¹² If the federal regulatory state were a country, it would be the world's 10th largest economy.¹¹⁴

The \$1.88 trillion number comes from

the Competitive Enterprise Institute's Wayne Crews, who compiles U.S. government regulatory data from disparate sources in his annual *Ten Thousand Commandments* report. The \$2.028 trillion number comes from W. Mark Crain and Nicole V. Crain, both of Lafayette College. Every few years since the late 1990s, the Small Business Administration (SBA) has published updated reports of their data. For undisclosed reasons, the SBA declined to publish the 2014 edition of their report, which was instead published by the National Association of Manufacturers under the title, *The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business*. The federal government's own in-house burden estimate ranges from \$57 billion to \$84 billion per year, but this only covers 115 selected regulations issued between 2002 and 2012. Those 115 come from more than 37,000 total regulations issued over that time, making this a less-than-complete estimate.¹¹⁴

Whichever numbers one prefers, the point remains that the United States' regulatory system creates significant barriers to entrepreneurship. That hurts the poor. Many countries' regulatory regimes are so bad that it is practically impossible to do business legally. In fact, the "Arab Spring" of 2011 began when a Tunisian street vendor, Mohamed Bouazizi, set himself on fire in protest at continued harassment

by officials over his supposed lack of a street-vending permit.

A research team led by Peruvian economist Hernando de Soto looked into how long it takes to legally start a new business or get legal title to land in countries around the world. In Peru, starting a small business took de Soto's team 289 days at six hours per day, and cost 31 months' pay at minimum wage.¹¹⁵ Legally purchasing a house in the Philippines, says de Soto, "could necessitate 168 steps, involving 53 public and private agencies and taking 13 to 25 years."¹¹⁶ The process for buying a single lot of state-owned land in Egypt takes five to 14 years.¹¹⁷

In such regulatory environments, people often turn to the black market, where entrepreneurs do not have access to the legal system to settle disputes. Unable to secure legal title to their home, they cannot borrow against its value the way many entrepreneurs easily do in richer, less-regulated countries. De Soto calls this huge amount of extralegal assets, along with many other types, "dead capital." He estimates the worldwide value of dead capital to be \$9.34 trillion as of 2000.¹¹⁸ Policy makers must work to remove the obstacles preventing this dead capital from coming to life.

Reform the Regulatory Process, Not Just Regulations Themselves

The need for regulatory reform is clear, in both rich and poor countries. A

comprehensive regulatory reform agenda should focus on three areas of policy: 1) minimizing barriers to entry, 2) maximizing government transparency, and 3) improving the rulemaking process itself. Each of these three areas has several fruitful avenues for reform that should appeal to everyone who wants to eradicate poverty. While this section mostly focuses on the United States, many of these reform proposals can be applied in other countries as well.

The rules of a game have a lot to do with how people play it, and with how it turns out. In baseball, a batter can foul off an unlimited number of pitches, so long as a fielder does not catch it on the fly. Such catches are relatively rare, so hitters can be bold when deciding whether to swing at a pitch. But suppose the rules were changed to make *every* foul ball an automatic out, caught or not. Batters would instantly become much more tentative. Pitchers would also adjust their strategy to induce more fouls. Such a simple change would cause a sea change in strategy—and in outcomes.

This holds an important lesson for helping the poor. For the regulatory game to have different results, it needs different rules.¹¹⁹ In the United States, the current rules of the political game make it easy to pass new regulatory restrictions that make escaping poverty more difficult. They also make it difficult to get rid of old rules with

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similar regressive effects. The reforms outlined below are no panacea, but they would do much to help consumers and entrepreneurs alike live better, longer, and more prosperous lives.

Timely issue of existing legally mandated transparency reports, such as the *Unified Agenda*.¹²⁰

Formally called the *Unified Agenda of Federal Regulatory and Deregulatory Actions*, the twice-annual *Unified Agenda* compiles recent and forthcoming regulations from more than 60 agencies. The number of new rules, which typically numbers more than 3,000, gives policy makers and entrepreneurs a rough idea of what Washington will be up to in the coming year or two. In recent years, the *Unified Agenda* has been published late (usually on a holiday break, when few people are paying attention), or not at all.

Another important report is the *Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities*, which compiles data on how much regulations cost. This report has been plagued by similar problems, and is sorely incomplete, since both agencies and the more independent Office of Management and Budget only perform cost-benefit analysis on a small subset of regulations—and even then, these estimates only occur before regulations come into effect.

There is almost no cost information available for regulations after they

take effect, when there is actual real-world data that can be collected. This is a serious transparency shortcoming that can be easily remedied by requiring more independent analysis of rules before and after they take effect, and as more empirical data become available.

Additional transparency reports, including annual report cards for every regulatory agency. Basic information about agencies such as their budget, staff size, major regulations enforced, and forthcoming regulations is already available to the public, but scattered among dozens of different sources. It would increase transparency for both policy makers and the public to have annual documents collecting that information in one place. One of us (Young) has put together some sample report cards from which agencies can build.¹²¹

Congressional votes on all new major regulations. In the United States, only the legislative branch may make laws. However, in the modern American regulatory state, a large share of lawmaking is being done by unelected bureaucrats at regulatory agencies. That is because Members of Congress often delegate away their legislative responsibilities to those agencies. If a regulation turns out to be controversial, expensive, or unpopular, a politician can deflect blame to the agency promulgating and enforcing the rule. Examples range from net neutrality to carbon emissions to health insurance subsidies.

The Regulations from the Executive in Need of Scrutiny (REINS) Act would make Congress more accountable for the authority it delegates to agencies and help curb agency overreach by requiring congressional votes on major agency regulations—those with at least \$100 million in estimated annual costs. By forcing Members of Congress to go on the record over which rules they support and which they oppose, the REINS Act would make it more difficult for politicians to pass the buck to the regulators they empower. The legislation has passed the House on three occasions and repeatedly stalled in the Senate. It should be a priority for the next administration and Congress.¹²²

A regulatory “budget” similar to the government’s annual fiscal budget.

Government spending is a perpetual topic of public debate. Regulation, however, rarely gets much attention. A large share of Americans have some idea of the size of the federal budget and the total level of federal debt, but few people have any idea of how much regulations cost. Much of this is due to a lack of transparency. In the United States, federal regulations impose economic costs on par with roughly half the federal budget.¹²³ This means the federal government costs about 50 percent more than most people think it does. To remedy this transparency problem, the federal government should be required to publish an annual regulatory budget of regulatory

costs, just as it is supposed to publish an annual spending budget. This simple exercise might spur agencies to prioritize some rules over others, and consider the basic notion of tradeoffs.¹²⁴

Five-year sunset provisions for all new regulations which can be renewed with a congressional vote.¹²⁵

The District of Columbia still has regulations for herding cattle inside city limits.¹²⁶ Federal regulations prohibiting curved driver’s side mirrors in cars are making cars less safe than they could be by keeping automakers from adopting new curved mirror technology that can triple the field of view with minimal distortion.¹²⁷ An easy way to get such obsolete rules off the books is to have regulations automatically expire after, say, five years, unless Congress votes to renew them. Regulations that are still useful, relevant, and effective should have no problems clearing that hurdle. Meanwhile, regulations that are harmful, costly, obsolete, or redundant can expire automatically.

Similar sunset provisions for regulatory agencies themselves.¹²⁸

Two federal agencies that have automatic sunsets are the Export-Import Bank and the Overseas Private Investment Corporation. Because of those sunsets, reformers have regular opportunities to enact needed reforms, or even abolish the agencies outright. In fact, the Export-Import Bank’s authorization expired for five months in 2015, and

Facing the threat of closure should give agencies a powerful incentive to behave reasonably and not abuse their authority.

the agency was unable to make new loans during that time. The state of Texas has had a sunset law for its agencies since 1977.¹²⁹ Since then, more than 80 government agencies have been abolished.¹³⁰ Facing the threat of closure should give agencies a powerful incentive to behave reasonably and not abuse their authority.

An annual independent commission that sends Congress a package of obsolete, redundant, or harmful rules for an up-or-down repeal vote.¹³¹

This proposal is inspired by the Base Realignment and Closure (BRAC) model of the 1990s. After the Cold War ended, the United States needed far fewer military bases. But no Member of Congress would vote to close a base in his or her district, because of the political pain a closure would cause. This led to billions of dollars of waste. The way around the problem was to task an independent commission with recommending which bases to close, and submit an omnibus package to Congress for an up-or-down vote, without the possibility of amendment. Members with closures in their districts could point to the greater good the bill would do, and deflect blame for local base closures onto the BRAC Commission, thus making base closures politically viable and allowing Congress to move forward. There is a similar dynamic with regulations. An annual Regulatory Repeal Commission or Regulatory

Improvement Commission could have similar benefits in simplifying the 175,000-page *Code of Federal Regulations*.

Occupational Licensing Reform

Benta Diaw was born and raised in Senegal, and eventually moved to the United States. She became an entrepreneur almost as soon as she became an American, opening her own natural hair salon in the Seattle area. Natural hair care eschews any kind of chemicals, dyes, and styling products, and relies solely on intricate braiding techniques. Diaw learned how to braid hair from her grandmother back in Senegal, and women in her family have been practicing the art for more than a century.

Washington State threatened to put Diaw out of business because she did not have a cosmetology license. This would have cost her thousands of dollars and required her to undergo 1,600 hours of training—the equivalent of almost a year of foregone full-time work—in services her salon does not offer, such as pedicures and nose hair trimming. The cosmetology training program does not cover African hair-braiding at all, which made the requirements worse than useless for Diaw and her clients. In effect, Washington State's cosmetology licensing program was preventing

Diaw from making a living. So she sued, and won.¹³²

Benta Diaw's story has a happy ending, but many others do not. Occupational licensing is one of the most common barriers to entry for entrepreneurs and workers, and many of these licenses target low- and moderate-income jobs. Today, nearly a third of American workers are not allowed to do their job unless they first get permission from the government.¹³³ Thirty states require carpenters and cabinet makers to get a license. Thirty-five states require a license to repair doors. Five states require a license to shampoo someone else's hair. Nine states require licenses for farm workers. Thirty-seven states license security guards. Twenty-six states license taxidermists. The list goes on and on.¹³⁴

Defenders of these regulations often claim they are needed for consumer safety, arguing you would not want to be operated on by an unlicensed brain surgeon. But shampooing someone's hair is rather different from brain surgery. Licenses for many such occupations are merely a protectionist imposition on the market that let incumbents keep out pesky competitors.

Another argument for occupational licensing is that it confers a degree of trust, in that the public can be sure that the holder of the license is qualified to do the job. That may have been the case

in a low-information society, where it was difficult to find out about a business' reputation for quality and service without a time-consuming investigation. But private alternatives to government licensure have existed for a long time.

Underwriters Laboratories (UL), the International Organization for Standardization (ISO), the American National Standards Institute (ANSI), and other organizations provide rigorous certification standards. If a consumer sees a UL seal on a lightbulb or a microwave oven, for example, she will know the product meets certain standards. Private sector regulation does not end there.

Public reviews and recommendations of nearly every business are little more than a Google search away. Online network businesses like Uber, eBay, and Yelp are built on this form of private regulation (which often applies to customers as well as vendors), and would go bankrupt if they did a poor job of it. Services like Angie's List reduce the need for governments to issue "badges of quality" by making it easy to find out if a hairdresser, plumber, or carpenter is any good at his or her job, based on consumers' recommendations. If government regulators were subject to competition, or if people had a way to judge the value of their services, they might do as good a job as their private sector counterparts.

Occupational licensing is one of the most common barriers to entry for entrepreneurs and workers.

The sharing economy, in effect, offers regulation without regulators.

Instead, in many government-regulated industries, license issuers are incumbent businesses whom government has been given the power to pick, choose, and limit their competition. Unsurprisingly, these incumbents often use occupational licensing as a cudgel to keep out potential competitors.

Some barriers to entry do not even pretend to have anything to do with consumer safety. For example, in many cities taxi regulations require simple ownership of a license, known as a medallion, but little or no qualification or training. That is why the emergence of ride-sharing services like Uber and Lyft has proved so disruptive to taxi operations. According to an Uber source, only 4 percent of taxi drivers who apply to drive using the Uber platform meet the company's qualifying standards.¹³⁵ Uber's screening system for drivers provides a better guarantee of quality than a traditional taxi license. Riders can rate each trip they take from one to five stars. Uber pays close attention to these ratings, and will terminate drivers who do not do a good job serving customers. Similarly, drivers can rate riders, allowing them to refuse customers who have earned a bad reputation—giving customers a strong incentive to be polite and courteous. The sharing economy, in effect, offers regulation without regulators. This two-way check on bad behavior is lacking in the legacy taxi industry.

We mentioned earlier the economist Hernando de Soto's work on the problem of "dead capital." Even in the developed world, there are trillions of dollars of dead capital. Spare bedrooms, vacant apartments and condos, and cabins and vacation homes do not do much good when they sit empty. AirBnB helps bring that dead capital to life by making it easy for owners of unused space and vacationers in need of accommodations to get together and make a deal. Travelers get better accommodations and better prices than many hotels can offer—which gives hotels an incentive to offer better prices and services—and property owners get to make fuller use of capital they already own, whether a spare bedroom or an apartment they occupy only part-time. It is a win-win—except for the hotel industry, which has been lobbying hard to shut down this new form of competition. In many cities, AirBnB has fallen afoul of hotel-friendly licensing laws and legal battles have ensued, but mostly for political reasons, not from consumer dissatisfaction.

Finally, there are regulations that stop new businesses from getting off the ground because they form a disincentive to hiring, such as the minimum wage and compulsory collective bargaining. In all of these cases, regulations form barriers to entry for small businesses and entrepreneurs.

Some countries, including the United Kingdom, have recognized this problem and created small business licenses that exempt companies from a wide range of regulations until they reach a certain size.¹³⁶ While this approach comes with problems of its own, it is certainly an improvement over the status quo. The U.S. federal government should consider a similar policy, with states doing likewise.

Even now, many regulations have different phase-ins depending on a business' size. For example, companies with only one employee are subject to the Fair Labor Standards Act, Equal Pay Act, Polygraph Protection Act, and several other regulations. It is not until that company grows to four employees that it also becomes subject to the Immigration Reform Act, 15 employees until it needs to worry about the Americans with Disabilities Act, 20 employees until the Age Discrimination Act takes effect, and so on.¹³⁷ As a result, there are regulatory thresholds that artificially limit the size of companies by employees.

While it is considerate of regulators to spare the smallest businesses the full brunt of their compliance costs, the sheer number of different phase-ins adds an additional layer of complexity to regulatory compliance. State and federal governments should consider a blanket exemption from most or all regulations for all startup businesses

or all businesses under a certain size. While this creates a rather obvious incentive for businesses to remain small, it would be a smaller problem than the status quo, with its complex layer of exemption tiers.

Regulations also cost smaller businesses more, on a per-employee basis. According to economists Nicole V. Crain and W. Mark Crain, businesses with fewer than 50 employees paid \$11,724 per employee to comply with federal regulations; larger businesses paid \$9,083 per employee, a competitive disadvantage of \$2,641 per employee for small businesses.¹³⁸

The goal of pro-market reforms to help the poor is to create a level playing field for all entrepreneurs. Their ideas should compete on their merits, not on political connections or legal savvy. When it comes to today's regulatory climate—and not just in America—the current system is simply not up to the task. Hence our call for reform.

Conclusion

The debate over economic inequality has yielded more heat than light. Widespread misunderstanding of the difference between relative and absolute poverty means that one of the most important new works on economic inequality virtually ignores the poor. French economist Thomas

For the first time in human history, it is possible to end absolute poverty altogether.

Piketty, in his bestselling book, *Capital in the 21st Century*, is so focused on mathematical ratios between high and low incomes that he almost forgets to take a look at what living standards are actually like for people at the low end, and how to raise them over time. And when he does, he quickly dismisses such matters. He, and many others, should focus on people, not ratios.

A monomaniacal focus on relative poverty, which is not at all unique to Piketty, has led to misguided public policy proposals. Piketty's proposed global tax on capital would do nothing to relieve absolute poverty. It would also slow down or even stop its steady eradication. The minimum wage, while popular, not only fails to relieve absolute poverty, it actually *increases* inequality among the poor, as basic economic analysis shows. Expanded collective bargaining is similarly ineffective at reducing absolute poverty, and increases inequality both

within and between the working and middle class.

For the first time in human history, it is possible to end absolute poverty altogether. The fight to do so will be one of the 21st century's defining issues. The way to end absolute poverty is not to smooth out income ratios with redistribution, minimum wage laws, or expanded collective bargaining, but by freeing people to innovate, and encouraging the entrepreneurial spirit. It is by ensuring that the price system that guides everyday human behavior is honest, stable, and predictable. It is by ensuring that barriers to entrepreneurship are as low as possible, so anyone can give it a try. As Competitive Enterprise Institute founder Fred Smith likes to say, you don't have to teach grass to grow; you just need to move the rocks off of it. Removing economic rocks is one of the world's most pressing matters.

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