Poverty amidst affluence?

BIG GOVERNMENT: HOW TO CREATE POVERTY

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Globally, poverty is decreasing dramatically. The more open and globalised poor countries are, the more rapid is the increase in their growth and incomes. But many countries in Western Europe have serious problems. They largely followed a path of government intervention in society. In reality, however, the freer a country's economy the less poverty it has. Government intervention is counter-productive and has become a fight against wealth. The over-taxed and heavily regulated labour markets of Western Europe have led to social exclusion for large groups: the new poor.

Introduction

Karl Marx designed the theory of how capitalism creates poverty. Charles Dickens penned a lively description of how this allegedly worked. Many others followed. A permanent battle between owners of capital and workers is supposed to be raging, where the latter will be usurped by the former, and thus see their living standards decline. Some people are poor because some people are rich – in a world of static resources. This image of how society works did not disappear with the nineteenth or twentieth centuries.

The main method to stop the poor from getting poorer, and the rich from getting richer, was considered to be state intervention in society. Instead of introducing this kind of society by revolution, as some did, Western Europe embarked on a journey of pragmatic socialism: high taxes to redistribute resources, collective ownership, public systems for social security, public welfare services and labour market regulations. Indeed, today, most countries in Western Europe share a so-called 'social model' largely based on this idea.

The idea is to adjust for 'market failures', to avoid the perceived adverse consequences of capitalism. By making the state a large part of society, with numerous interventions in otherwise free exchange, social justice is supposed to be enhanced. When the state constitutes a big share of society, much is decided and owned collectively and decided by majority rule by elected politicians. This is regarded as more democratic than when people decide by themselves. One main aim is to fight poverty.

When countries today face problems and challenges, not least poverty, it is of course very relevant to know which theories and assumptions have been right historically. Whether capitalism creates poverty and state interventions are the only way to help the poor, or not, is an empirical issue with strong moral implications. It is beyond doubt that many countries in Western Europe have problems today – with poverty, unemployment and social exclusion – and how one interprets the causes of this will determine what the solutions might be.

Wealth creation

The Economist (19 December 2002) pointed out that: 'Marx was not a scientist, as he claimed. He founded a faith. The economic and political systems he inspired are dead or dying. But his religion is a broad church, and lives on'.

We have a model of society with vast state interventions because it is assumed that the free economy creates severe adverse consequences, not least in terms of poverty. And the state was supposed to reverse this. But if this were true, why would these Marxist systems be 'dead or dying'? And why would there be so many problems today?

John F. Kennedy famously pointed out once that if Marx had lived in the USA, by the 1960s he would not have had to worry as much about liberating workers from capitalism. He should be more concerned with the question of how to build enough parking lots for them. But Marx and Engels (1848) did not deny the wealth creation of capitalism: '[It has] created more massive and more colossal productive forces than have all preceding generations together'. They just believed that it would not last.

The economic development of the Western world during the roughly 150 years since that time has proven the basic Marxist analysis of usurption of the majority to be wrong. The average income for ordinary people has increased at least ten-fold in the Western world during the last century. And since this is the *average* income, this increase is not the result of government redistribution of resources. It is the result of more resources being created and the wealth from that being spread to both owners and workers.

Our societies have become vastly more wealthy during the last 150 years. And this is not just a matter of figures and money. Life expectancy has more than doubled; previously incurable diseases are cured; housing, food and clothes are of a totally different quality; freedom to choose the life we want is greater; only a tiny share of income is needed to pay for basic necessities; and technological progress has opened up the world. And this is not just for a few in the rich countries. The resources of the Western world have grown enormously, wealth has spread to ordinary people and the developing countries are now growing strongly.

Improvements for the world's poor

The global development of today provides a number of facts of relevance for an analysis of economic and social progress. Most people agree that capitalism has spread to larger parts of the world than ever before, under the name of globalisation. What has happened to poverty in the world during that time? It has decreased sharply. In 1950, 60% of the world's population lived in extreme poverty; in 2000, the share was 20%, according to statistics from the World Bank. Those who believe that capitalism creates poverty will have a hard time explaining how poverty can decrease faster than ever in the globalised world.

During the last 20 years, growth has on average been substantially higher in developing economies than in developed ones, roughly twice the rate (IMF). The rich get richer, but the poor also get richer – and this is much more rapidly than when today's rich countries left poverty. Not least has this been a fact in China and India, where hundreds of millions of people have been lifted out of poverty. This development obviously started after China opened to capitalism and India reduced socialism and protectionism. The globalised developing countries have grown by, on average, 5% a year during the 1990s while the economies of non-globalised 'developing' countries shrank by 1% a year (World Bank).

Growth matters for the basics of life – the higher the GDP per capita, the higher the share of children that survive their first year (see World Health Organization, *World Health Chart*). The connection is very strong for all countries. But – and this should be a wake-up call for those who believe in the state as the solution – there is no connection between the degree of public healthcare spending and the share of children that survive their first year. In 1900, average life expectancy in the world was a mere 31 years; today it is 67 years and rising. Life expectancy in poorer countries has improved even faster. In China it has surged from 41 years in the 1950s to 71 years today; in India it is up from 39 years to 63 years (Goklany, 2006).

Basic questions

Still, in this world of progress and wealth creation, there are hundreds of millions of people who still live in extreme poverty. Furthermore, alongside wealth, there is poverty: when one walks the streets of London, New York or Berlin, one occasionally encounters obviously poor people. And these are cities with enormous wealth, in some of the richest countries of the world. Poverty is also apparent for a visitor in the *banlieues* of Paris, in the rural countryside of Sweden and in towns of the old manufacturing industry in Britain. Wealth may have increased and spread to many, but certainly not to everyone. Not even in the wealthiest countries. Is this because of capitalism or because of the lack of it?

First of all, it has to be underlined that, in the long term, it really is wealth that should be explained, not poverty. Today, it may be said that there are great differences in income both between countries and within countries. But a few hundred years ago, living standards were roughly the same for almost everyone – extreme poverty was the rule. What we have had since then is a development where wealth has been created during a few hundred years. Now, a majority of the world's population is not poor. So the question should rather be: what kind of society is the one that will allow more wealth to be created and reach everyone?

Relative or absolute?

In order to discuss the causes of poverty and possible solutions, the term has to be defined. It is very common in the public debate and in sociological research – where much of the research on poverty is done – to have a relative definition. For example, if you have an income below 60% of the average income in your country, you are considered to be poor. This does not take into account the level of the average or living standards of the poor – in terms of, for example, food, housing, cars, access to school or healthcare. Any country with big income differences will be considered to have a high degree of poverty.

A different measure of poverty would be an absolute measure based on a fixed income. Say, for example, that a household with an annual income below £10,000 after tax is considered poor in any country in the Western world. Thereby, it would be a measure of actual poverty. It doesn't matter if £10,000 is 40%, 60% or 80% of the average income. This would be a measure of poverty, whereas the relative measure is actually a measure of equality – which is a different matter.

This is very important. The USA is often blamed for having substantial poverty despite being the wealthiest country in the world. With the relative measure, they do have substantial poverty, but with the absolute measure, they do not. In fact, the average income level of the poorest quintile is roughly the same as the average in Western Europe – but well below the US average. Conversely, a country like North Korea is by a relative measure considered to have little poverty, since everyone is poor. But with an absolute income measure, poverty is widespread.

This will also affect the policy outcome. Are we fighting against income differences or against poverty? If the former, then it is equally important to make the rich less rich as it is to improve conditions for the poor. And it would, by that definition, be a bad thing to have a society where the richest are billionaires and the poorest are millionaires. Redistribution would be justified and growth would be irrelevant. But what if that kind of society actually leads to lower incomes for the poorest in absolute terms because of lower economic growth?

Poverty in the UK, USA, Sweden and Ireland

In 1990, the share of the population with an income after tax of less than $20,000 was 42.5% in Ireland, 39.5% in Britain and 19% in Sweden. In 2004, the share in Ireland was 14%, in Britain 19% and in Sweden it was 19.5%. Two of the three countries were successful and one less successful in fighting poverty. The incomes of the poorest 10% of the population increased between 1995 and 2004 by 79% in Ireland, 59% in Britain and 10% in Sweden (Euromonitor, 2006). Ireland and Britain undertook substantial free-market reforms, whereas Sweden did not. In absolute terms, the fight against poverty has clearly been more successful in Ireland and Britain.

In this context, it may be relevant to make more comparisons with the USA. During the last few years, there have been many critical reports in the media about the USA, not least concerning poverty. Hurricane Katrina seemed to highlight the problems. But many facts speak of another reality. Bergström and Gidehag (2004) point out that the average person in 45 American states is richer than the average person in any European country except Luxembourg. In the USA, the 'poverty rate' is considered to be an income level of $10,000 a year, which implies that 12.7% of the US population is poor (US Census Bureau). The equivalent measure in Sweden is considered to be roughly the same – though about $12,000 with today's weak dollar – and 39% of Swedes fall below that line, according to the Swedish Statistical Board. The figure is 24% if only people of working age are considered (i.e. not retired people). Also, most people in the USA are poor for just a short period – often, they are immigrants – whereas in Europe, poverty tends to be more permanent.

Needless to say, the USA is a more market-oriented country with less government intervention than most countries in Western Europe. This is not to say that the USA is a totally capitalist country: on the contrary it too has significant government intervention, and in some ways even more so than European countries. But the US economy is more free than most European economies, and it has had a higher economic growth rate and also seen real improvements for the poor. At the same time, the USA has had an increase in income differences – again, something that is possible at the same time as poverty decreases.

The fight against income differences

There is good reason to believe that a country where the government intervenes in order to minimise income differences might be less successful in the fight against poverty. If life disincentives are provided to be more economically active and more productive it is less likely that people will create wealth. If education, investments, work or entrepreneurship are punished with very high taxes, fewer such activities will probably take place. High and progressive taxes, combined with high social security contributions, together with high social security payments to those who do not work, will create incentives against education, work and entrepreneurship.

One statistical example might be the so-called employment trap. That is, the difference in income for a person who goes from welfare to work. In the USA, income will rise by 30% if a person moves to a job from being on unemployment benefits, in Estonia the increase is 35% and in Slovakia 57%. But in France, for example, the increase would be a mere 18% and in Sweden only 13% (Eurostat). Of course other parts of the system for unemployment benefits, such as limits on how long a person can receive it, and also the tax system, will affect this. But *ceteris paribus* the level itself will have this effect. When you are unemployed, the possibility to have a rise in income is limited. And if the incentive to actually take a job is weak, many may refrain from taking a job, from which income could rise with time. Thus, more people may be locked in unemployment, as a consequence of state intervention.

The fight against inequality might become a fight against wealth and thus against opportunities to decrease poverty. Vast state interventions as a method might become counter-productive and actually keep people in poverty who would otherwise have been able to lift themselves to better living standards. And the so-called 'social model' of Western Europe has clearly been designed to fight income differences rather than fight poverty.

What happened to Western Europe?

As outlined above, Marx was wrong: most people in the world have seen their living standards rise rapidly since his time. In particular, this is the case in many developing economies of today's globalised world. And economic growth is the prerequisite for any social improvements. Western Europe was the first part of the world that actually embarked on the road to prosperity. Free-trading cities, innovations such as banking and the developments of stock exchanges, property rights, and reduced economic and political power for the Church, paved the way. Industrialisation followed, and now we are heading for the services society. And Western Europe has continued to become richer during the last few decades too – but it has slowed down and problems have mounted. What has happened?

Average incomes in Europe rose from about 40% of the average in the USA in 1950 to about 70% by 1973. That development then stopped and was reversed. Today, the average income of a European is below 70% of that of a US citizen and is still falling (*The Economist*, 23 September 2004). At the same time, most countries in Western Europe introduced the 'social model' of big government. Taxes as a share of GDP increased from 15–35% in 1965 to between 30% and 50% today. At the same time, the US tax pressure increased only from 25% to 27% of GDP (Karlson, 2004; OECD, 2006).

Of course there is no single explanation, and there have been differences between European countries. But neither is the fact that the higher tax pressure and lower economic growth occurred during the same period a coincidence. There are numerous studies that show how high taxes have put a brake on economic growth (Katz, 2006): for example, productive efforts become less attractive and public spending distorts resource allocation decisions and displaces private-sector activity. There are also numerous cases where countries have decreased taxes and experienced strong positive effects in terms of growth. The low and flat taxes in several countries in Eastern and Central Europe have had a role in their success. And when Ireland decreased its corporate tax rate from 50% to 20%, corporate tax revenues tripled as a share of GDP (Mitchell, 2005).

Developments in Western Europe during the last few decades must be considered negative. Increases in incomes are more important for those with low incomes than for those with high incomes. When incomes rise by as much as in Ireland, for example, this allows the poor to buy basic goods and some luxuries – perhaps for the first time. When the economic growth rate is low, incomes will stagnate too and the poor will be limited to buying only basic goods. To the extent that the so-called social model of big government has contributed to a lower growth rate – and much suggests that it plays a main role – it has been counter-productive. It was said to be introduced to help the poor, but did the opposite.

The labour market and poverty

In Western Europe, the state often intervenes to a large extent in the labour market. This is an integral part of the 'social model', with the main purpose of helping ordinary workers. There is not just intervention in terms of regulations concerning hiring and firing – there are regulations as to how, where, when and with whom you should work. The state puts high taxes on work as well as gives that money to people who do not work. The trade unions are given lots of power to determine wages collectively. And, not least, a big part of the workforce is employed by the public sector.

There are thus numerous so-called 'social' state interventions in the labour market. What have they led to? Between 1970 and 2003, employment in the USA increased by 75%. In France, Germany and Italy, it increased by 26% (Gersemann, 2004). In 2004, only 13% of unemployed workers in the USA were unable to find a new job within 12 months; in the EU, the figure was 44% (Furchtgott-Roth, 11 August 2005). In the EU, average youth unemployment is 17%; in the USA it is 10% (Eurostat).

But the best comparisons can be made within Europe itself. Denmark has an employment rate of 76%, but Poland is far lower at 53%. Youth unemployment is above 20% in Greece, Italy, Sweden, France, Belgium and Finland and below 8% in Ireland, the Netherlands and Denmark (Eurostat). In the EU's 15 member states, between 1995 and 2004, the development of employment was also very different between the countries. In Ireland, the Netherlands and Spain, the increase in employment was the highest; in Germany and Austria, it was almost zero (European Commission, 2005).

What were the differences between the successful countries and the others? Firstly, the labour market was substantially freer in the countries that succeeded in creating new jobs (as measured by the Heritage Foundation *Index of Economic Freedom*). Secondly, payroll and income taxes were more than ten percentage points lower in the five best economies, as measured by the rate of job creation, compared with the five worst (OECD, 2005). Thirdly, the levels of benefit from the state for unemployment and sick leave were lower in the best performing economies (European Commission, 2004). What the successful countries have in common is: freer labour markets, lower taxes, and lower social security benefits and contributions.

Being able to work and earn money is essential to be able to build prosperity, for life satisfaction in general, and also to raise living standards. State interventions in the labour market reduce the number of new jobs and many people in Western Europe are forced out of work. There may be fairly generous unemployment benefits, but that can never be compared with a real job and a salary – being out of work does not lead to better career opportunities, whereas being in work, even in a low-paid job, does.

The young and immigrants suffer the worst effects of the so-called social model. They are pushed out of work and society and into poverty. Youth unemployment is very high, as has been mentioned, in several European countries. Young, often well-educated, people do not get a chance to enter the labour market because of regulations that protect those who have jobs already. For an employer, it is always a risk to hire someone, and the less you know about a person, the greater the risk. If the state makes firing very hard, employers will hesitate to hire people, especially those that they know little about, such as the young and immigrants.

And entrepreneurship is often not an option. There are heavy tax burdens for smaller businesses too, in the countries with a 'social model'. It might be hard to find investment capital, because few people are rich enough to be capitalists. Regulations, and the severe consequences of not complying, can discourage risk-takers. And to a large extent, many service sectors like healthcare and education are basically shut off from entrepreneurship, since they are in public monopolies. PricewaterhouseCoopers and the World Bank analysed 175 countries in 2006 concerning how many hours a year it takes to deal with tax bureaucracy for a company. The number of hours in European countries is lowest in Switzerland (68) and Ireland (76) – and highest in Spain (602), Portugal (328) and Finland (264).

Creative destruction and work

Since the beginning of capitalism, there has been an ongoing development of what Joseph Schumpeter later referred to as 'creative destruction'. Entrepreneurs are free to invent, they will compete and consumers are free to choose – this leads to a society of constant improvements where the old gives way for the new. This is true for goods, services, factories and jobs. It has been estimated that three-quarters of all the products today did not exist in any form 100 years ago (Nordhaus, 1997). And the remaining quarter is probably a lot better and cheaper today. But for the new to come, the old must give way – and not be protected by the state. It may not always be easy to allow radical change, but trying to stop change would be like trying to stop society from improving.

In today's world of a globalised economy, change speeds up. Production is rapidly being restructured, old processes, products and jobs disappear. Ideally, a European country should end up where Ireland is. Employment in manufacturing has decreased by some 10% since the year 2000, but total employment is up by 10%. For every job lost, two new ones were created – in the service sector. And the larger the share of services in the economy, the higher is GDP per capita and the lower is unemployment, according to data from the World Bank (2005).

In order to be successful in a global economy, society has to be flexible. And the more the government intervenes, the less flexible society becomes. There is a very clear connection between the degree of economic freedom and economic growth (see the Heritage Foundation *Index of Economic Freedom*). In Anglo-Saxon countries, state intervention is more limited than in the rest of Western Europe. And they are successful in terms of employment – and in the fight against poverty, as has been mentioned. But in continental Western Europe, many people who lose their jobs do not get new ones for very long periods of time. Instead, they remain inactive, often on government programmes such as sick leave, early retirement or labour market programmes: they have become the new poor.

Following EU enlargement with ten new member states, of which eight are in Central and Eastern Europe, there has been a lot of debate about the migration of people who are willing to take jobs at wages below prevailing rates: the 'Polish plumber' as the typical migrant is often characterised. Several countries in Western Europe created barriers against the free movement of labour from the new member states. The citizens from the new EU member states were basically stopped from moving to other EU member states to increase their living standards and rise out of poverty. There were fears that they would take jobs or live off generous welfare benefits. In both cases, big government is the problem. It is the main reason behind too few new jobs and generous benefits. Three countries – Britain, Ireland and Sweden – did not erect barriers and a pattern quickly appeared in terms of labour movement. During 2004, several hundred thousand people came to Britain and Ireland, but only 2,000 came to Sweden. This may partly be because of language barriers but it is also likely to be because there were many jobs in Britain and Ireland but not in Sweden.

Causes and myths

It may be considered odd that the major countries of Western Europe stay with a model that is supposed to improve social conditions but largely does the opposite. But there are explanations. Of course, one reason is purely political: it is not easy for the same political parties that introduced this model, and argued for decades for it, to just turn the system around. Another reason can be explained by public choice theory. It is easy to let the state and its bureaucracy grow, and it will grow as a consequence of internal mechanisms, but it is very hard to shrink the state. Anyone who tries to do so will face many strong opponents with power and privileges in today's order.

Another main cause of the situation has been referred to as 'insiders and outsiders'. Those on the inside are protected and care more about remaining as they are than they do about the vast numbers (though still a minority) of people on the outside. They do not want to give up their own 'cradle to the grave' security so that others can have a job. But in today's global, changing, economy, even formerly secure jobs become insecure; and in a regulated labour market with few new jobs, job insecurity has greater costs. Labour market regulations thus tend to create a double insecurity, both for insiders and outsiders.

There are also myths that underpin the current order. One myth is that without state intervention, capitalists would get richer but everyone else poorer: there would be 'social dumping'. But global development now shows this to be wrong, and so does the history of the Western world. We produce, per person, at least ten times more value today than we did a century ago, which is why labour is paid more. If we had not increased our productivity, no state intervention or trade union action could have created ten-fold wage increases. Moreover, if wages in a free market are set below levels justified by productivity, a competitor will benefit from offering employees a higher wage. Free competition works both ways. Thus, 'social dumping' is largely a myth; however, it is still part of the foundation of the 'social model'.

Also, it should be noted that the number of owners has increased strongly, both in terms of the number of shareholders and in our capacities as owners of pools of capital who are funding their future retirement. In several countries in Western Europe, the number of owners is actually higher than the number of so-called blue-collar workers. This implies that ordinary people also have a strong interest in returns from investments and capital, not just from wages. Proposals have also been made about how to tear down barriers so that more people can become owners and thus benefit not only as consumers from companies and jobs moving abroad.

This might be particularly relevant for societies in which rapid change and restructuring is occurring. As old jobs disappear, some new ones might be created, but perhaps not enough and perhaps not with the right competence profile. Then, it is important that people can have part of their income from something other than work and wages: for example, return on investments and ownership. Lower capital taxes, possibilities for private pensions and social security and direct ownership in state companies might be steps in that direction. Combined with the fact that wages do tend to increase in a free economy, such an ownership society would be the ultimate disproval of Marx.

Concluding remarks

To the extent that the countries in Western Europe still have a so-called 'social model' of big government, they have problems. The very foundations in society that create wealth and decrease poverty are oppressed. But the countries that did reform the most have not only increased the incomes and number of jobs for average people, but also have been more successful in fighting poverty. Income differences may have increased, but poverty has decreased. The old analysis of the consequences of capitalism is fundamentally wrong: it produces wealth not for only a few but for many. In today's globalised world, free-market reforms that restore wealth-creating capitalism – both in terms of flexibility to change and possibilities for ownership – are increasingly important for those who want to fight social exclusion and poverty.

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