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RESEARCH SUMMARY

REGULATION AND INCOME INEQUALITY
The Regressive Effects of Entry Regulations

Launching a business or entering a professional field can be challenging in its own right, but in some countries—including the United States—regulations can make it even more difficult to get started. For example, to become a professional hair-braider or a florist in certain states, a worker must complete hundreds of hours of training and pass multiple exams.

Entry regulations require would-be members of a specific profession to pass exams or meet education or experience requirements in order to obtain a license to work. Proponents claim that such regulations might improve the quality of service, but most studies have shown that there is no relationship between licensing and quality. Entry regulations may, however, increase income inequality by corralling poorer workers into lower-paying, unregulated fields or forcing them to operate illegally and incur the higher costs of doing so. If entry regulations require expensive education, testing, and fees, workers may choose instead to accept jobs that pay less and don't take full advantage of their skills.

A new study for the Mercatus Center at George Mason University examines the relationship between income inequality and the number of regulatory steps necessary to start a business. Looking at 175 countries and multiple variables, the study finds that there is a positive relationship between entry regulations and income inequality.

To read the study in its entirety and learn more about its authors, Mercatus senior research fellow Patrick A. McLaughlin and Mercatus MA Fellowship alumna Laura Stanley, see "Regulation and Income Inequality: The Regressive Effects of Entry Regulations."

STUDY DESIGN AND DATA

While previous income inequality research has focused on GDP growth, relative returns on capital and labor, economic freedom, and ethnic heterogeneity, there has been little investigation of the

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relationship between entry regulations and inequality. This study is the first to perform a cross-country test of this relationship.

- Data on entry regulations come from the World Bank's Doing Business dataset.
- Income inequality is measured by the post-tax, post-transfer Gini coefficient (a standard measurement of a country's income distribution), which comes from Federick Solt's Standardized World Income Inequality Database of Gini coefficients.
- Additionally, income inequality can be measured using the World Top Incomes Database, which provides data on the shares of income going to the top 1, 5, or 10 percent of workers across countries over an expansive time period.

KEY FINDING: ENTRY REGULATIONS CAN INCREASE INCOME INEQUALITY

Requiring a greater number of steps to open a business is associated with higher levels of income inequality.

- An increase of one standard deviation in the number of steps necessary to legally open a business is associated with a 1.5 percent increase in the Gini coefficient (i.e., an increase in income inequality) and a 5.6 percent increase in the share of income going to the top 10 percent of earners.
- While this finding does not imply causality, there is no theory that suggests plausible reverse causality: that greater income inequality causes entry regulations. Instead, the evidence suggests that a greater number of entry regulations leads to greater income inequality.

POLICY RECOMMENDATIONS

Income inequality is a primary focus of many politicians and policymakers. One possible cause of income inequality is entry regulations. Countries with more burdensome entry regulations—that is, countries where red tape makes it harder to set up a business—tend to also have greater income inequality. Policymakers should focus on three main policy goals to mitigate these effects:

- *Avoid establishing ineffective entry regulations.* Regulations should not be promulgated if they do not solve a demonstrable social problem.
- *Consider alternative policies to address relevant social problems.* Alternative policies could include mandatory disclosures, registration, certifications, and titling, among others.
- *Examine current licensing restrictions for unintended regressive effects.* Retrospective reviews of current licensing restrictions can help determine whether regulations have resulted in higher-quality service or have instead been ineffective.