THE TEXAS ECONOMY

O'NEIL CENTER FOR GLOBAL MARKETS AND FREEDOM ★ SMU COX SCHOOL OF BUSINESS ★ JULY 2016

The Real Secret Behind Texas' Job-Creation Machine

By W. Michael Cox and Richard Alm

Texans tout their state's prowess in creating jobs—with good reason. From January 2000 to June 2016, the Lone Star State led the nation with a net employment gain of nearly 2.4 million workers. Texas accounted for one in every five U.S. jobs added in the period.

Americans who live elsewhere don't always take kindly to Texas braggadocio, and they may protest that the employment tally just reflects Texas' size. So let's take away this advantage by putting the gains into percentage terms. Texas still looks like a job-creation star, with the state third behind North Dakota and Utah in job growth as a percentage of 2000 employment levels.

The skeptics might persist by arguing that Texas prospers because of an oil industry that simply pumps wealth out of the ground. That view, however, bumps into an inconvenient fact—the state's job-creation machine has continued to churn upward after oil prices fell by about 70 percent in 2014-15 (see *The Texas Economy,* March 2016).

If not size or oil, then what?

Our research points to the state's high degree of economic freedom. By keeping

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taxes relatively low and government relatively small, Texas gives the private sector more room to work. Market signals guide decisions on starting companies, expanding output, introducing new technologies, redesigning products, staying competitive and, if necessary, going out of business. Economic freedom is good for companies, of course, but it's good for workers, too—as we shall see.

Economic freedom may seem a subjective concept, tricky to quantify. In recent decades, however, economists have made great strides in using hard data to produce objective measures of economic freedom—first for nations, then for states. The annual *Economic Freedom of North America* (*EFNA*) report, co-authored by Dean Stansel, our colleague in the O'Neil Center, uses 10 data points to locate the balance between government and the private sector in each U.S. and Mexican state and each Canadian province.

The latest *EFNA* report finds Texas tied with Florida as this country's third most economically free state, just slightly behind New Hampshire and South Dakota. Texas' high ranking in the latest economic freedom report isn't a fluke. Since the first index in 1980, the state has never been below seventh—and in many years, it has ranked No. 1.

EFNA incorporates several dimensions of economic freedom, but the one that most directly relates to job creation focuses on the labor market. State governments impose rules and regulations that impact pay rates, hiring practices, employment conditions, union membership, occupational qualifications and the procedures for cutting jobs or closing facilities when business conditions falter. These measures may be well-intentioned or self-serving; they may make some better off and others worse off. Yet, they interfere to some degree with the freedom of employers and individual workers to set terms of employment.

The *EFNA* report shows that state interventions erode labor-market freedom—but does it matter? To find out, we'll examine the relationship between labor-market freedom and state-level employment growth. Then we'll turn to real wages to ask whether states with

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KEY TO JOBS: HOW STATES RANK ON LABOR-MARKET FREEDOM (AVERAGE SCORE, 2000-13)

1 Virginia	8.14	11 North Carolina	7.43	21 Rhode Island	7.05	31 Kansas	6.88	41 Hawaii	6.42
2 Maryland	7.95	12 Pennsylvania	7.39	22 Minnesota	7.03	32 Maine	6.84	42 Wyoming	6.39
3 Florida	7.85	13 Nevada	7.39	23 Indiana	7.02	33 Kentucky	6.79	43 Michigan	6.33
4 Colorado	7.76	14 Arizona	7.34	24 Arkansas	7.00	34 Wisconsin	6.79	44 Oregon	6.25
5 New Hampshire	7.76	15 Utah	7.31	25 Idaho	6.96	35 Ohio	6.77	45 Mississippi	6.09
6 Georgia	7.62	16 Connecticut	7.21	26 Illinois	6.95	36 Iowa	6.72	46 New York	6.04
7 Tennessee	7.60	17 Delaware	7.21	27 South Carolina	6.94	37 California	6.70	47 Washington	6.03
8 Massachusetts	7.56	18 Nebraska	7.18	28 Vermont	6.94	38 Alabama	6.65	48 New Mexico	5.83
9 Texas	7.54	19 Missouri	7.12	29 New Jersey	6.90	39 Louisiana	6.61	49 West Virginia	5.80
10 South Dakota	7.49	20 North Dakota	7.08	30 Oklahoma	6.89	40 Montana	6.45	50 Alaska	5.58

high labor-market freedom are creating good jobs.

Freedom means more work

In the EFNA, Stansel and his co-authors use three broad indicators to calculate state-level labor-market freedom:

• *State and local government jobs as a share of total employment*. This indicator gauges the relative size of the private and public sectors. The larger the share of employment provided by private companies, the greater a state's labor-market freedom.

• *The minimum wage relative to local per capita income.* This ratio tells us the degree to which employers and workers negotiate freely to find market pay rates. The higher the minimum wage, the more it erodes freedom.

Minimum wages may raise pay for low-wage workers who keep their jobs, but they also reduce employment opportunities and make it difficult for less-skilled workers to gain a foothold in the job market.

• *The percentage of employees who are union members.* The unionization rate measures the power of organized labor to use its clout to determine pay rates and workplace practices. Labor markets tend to be freer in states with right-to-work laws, which prohibit contracts that make paying union dues a requirement for employment.

Combining the three broad indicators yields a gauge of labor-market freedom on a scale from 1 to 10, with higher values indicating greater freedom. The latest *EFNA* report, using data for 2013, finds the freest labor markets in Virginia, Maryland and Florida. Texas comes next in a tie with Massachusetts, New Hampshire and South Dakota. Among the states with the least-free labor markets are Mississippi, New York, Washington, West Virginia and Alaska.

We want to look at state-level job creation since 2000—so the latest readings aren't enough. To get a longer-term view of labor-market freedom, we average each state's scores for the past 14 years. Virginia, Maryland and Florida remain the leaders. Texas slips to ninth—still high, with a suggestion that the readings have been improving in recent years. New Mexico, West Virginia and Alaska show the lowest 14-year average labor-market freedom (*see table, first page*).

To display our results more clearly, we divide the states into five groups of 10, or quintiles. The 10 states with the freest labor markets added a total of 5.5 million jobs from 2000 to 2016 (*see chart below, upper panel*). This quintile accounted for about 46 percent of the nation's employment growth in the period. Even among this group of states with high labor-market freedom, Texas stands out, accounting for almost 44 percent of the top quintile's net gain in jobs.

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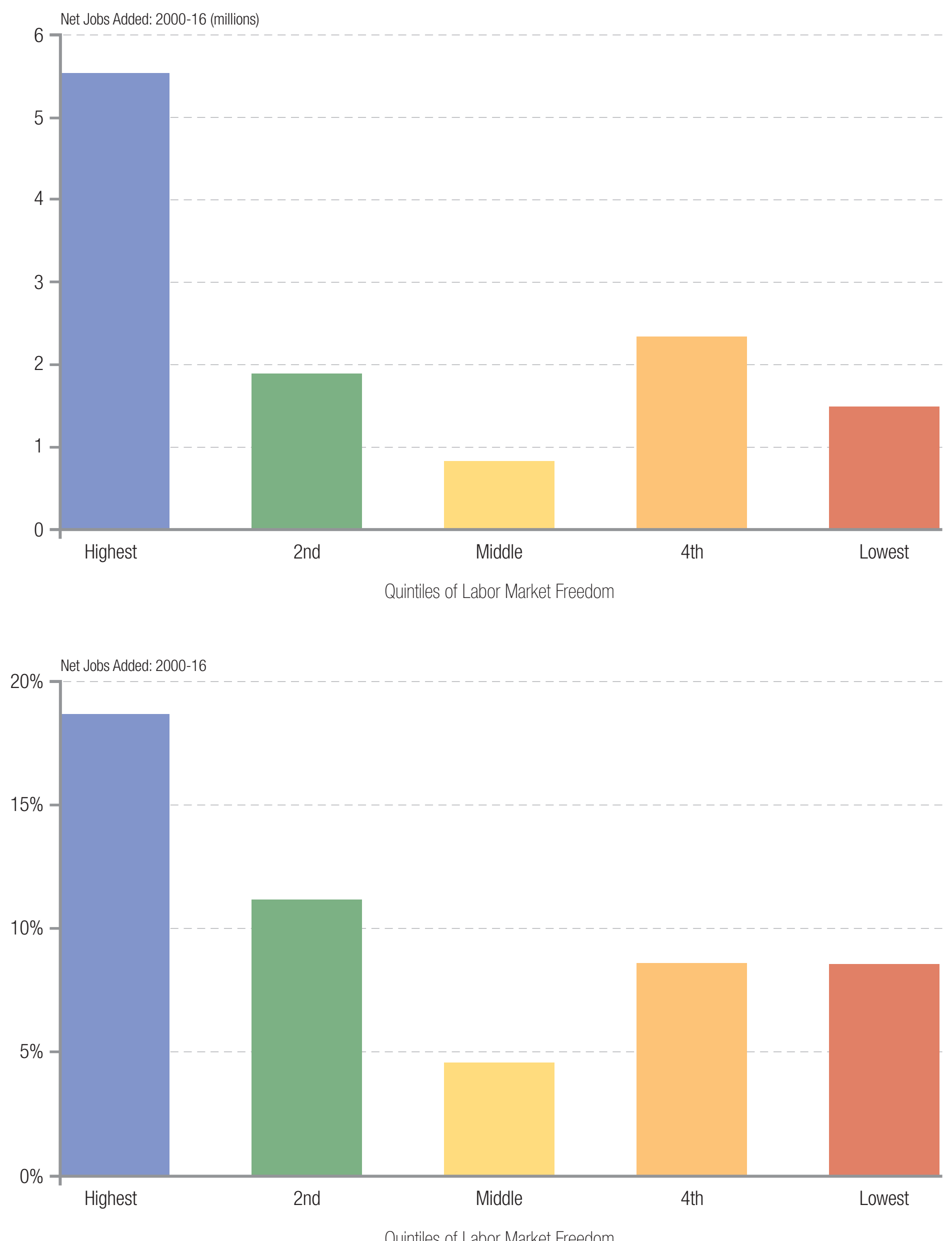
Moving to quintiles with lower labor-market freedom, job creation drops off sharply. The second-freest group added less than 1.9 million jobs since 2000. The middle quintile struggled, gaining just 840,000 workers. The fourth quintile did better with a net gain of 2.3 million jobs, mostly because of the gains in California's high technology-driven economy. Job creation drops off again for the states with the least labor-market freedom.

As we pointed out for Texas, size confers an advantage when measuring absolute job growth. So we once

STATES WITH FREER LABOR MARKETS CREATE MORE JOBS



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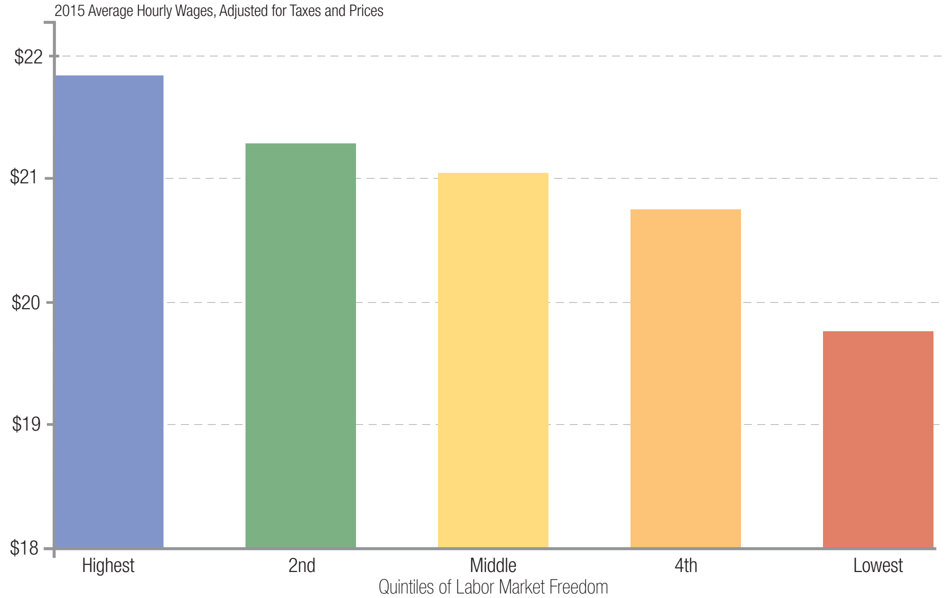
STATES WITH FREER LABOR MARKETS PAY HIGHER WAGES



again look at the employment gains in percentage terms. The 10 states with the greatest labor-market freedom saw job growth of 18.6 percent since 2000 (*see chart previous page, lower panel*). The rate drops to 11.1 percent for the second quintile, and it doesn't do better than 8.6 percent for the 30 states with the least labor-market freedom.

In an earlier study, we looked at labor-market freedom in the nation's 100 largest metropolitan areas (MSAs). The results were similar—faster job creation and freer labor markets go together. The top 20 percent of MSAs in economic freedom saw job growth of 12.9 percent from 2005 to 2015, compared with 4.8 percent for the least-free group.

The advantage for freer labor markets shouldn't be surprising. The interplay between supply and demand makes labor markets more efficient and lowers the costs of hiring and retaining workers. These free labor markets are attractive places to do business, both for existing firms as well as those looking to relocate. Where labor-market freedom is low, companies become reluctant to hire workers and often seek move operations to places with fewer restraints.

Freedom pays better, too

Although labor-market freedom stimulates job creation, some may still worry that it tilts the playing field in favor of employers—for example, wages might be bid down. The data say otherwise—at least when we look at average hourly wages adjusted for the cost of living, including differences in housing prices and tax burdens.

Measured in unadjusted dollars and cents, pay is often higher in places with high living costs (especially housing) and taxes. The raw data, for example, shows that employers in New York, one of the laggards in labor-market freedom, pay the nation's fourth highest average wage—$28.78 an hour in 2015.

After adjusting for its high prices and taxes, New York's average real wage falls to $18.50 an hour, dropping the state from fourth to 43rd in the ranking. The highest adjusted hourly wages are in Washington ($25.70), Virginia ($24.90) and Texas ($24.46).

States with the lowest average real pay rates are Hawaii ($13.23), Oregon ($16.22), Maine ($17.16) and West Virginia ($17.96).

Once again, we look at quintiles of 10 states. In 2015, tax-and-price adjusted median wages averaged $21.90 an hour in the 10 states with the freest labor markets (*see chart above*). The average after-tax real wage declines with each quintile of lower labor-market freedom, reaching $19.75 an hour in the least-free group.

The MSA study also found higher pay in the freest labor markets. In the 100 largest metropolitan areas, average after-tax real wages were nearly 10 percent higher in the top quintile than in the bottom quintile.

The link between freer labor markets and higher real wages makes economic sense: Freer, more vibrant labor markets increase growth and demand for workers; employers compete for these workers, adding some upward pressure on after-tax real wages.

Freedom always in jeopardy

The prospect of more jobs and higher real wages should push the country toward freer labor markets.

Some trends point in that direction. Fewer American workers, for example, are joining unions. Among wage and salary workers, union membership declined from 35 percent in 1953 to 22 percent in 1980 to 11 percent in 2015. In the private sector, union membership is down to just 6.7 percent.

Right-to-work laws are spreading. In 2015, Wisconsin became the nation's 25th state to prohibit labor contracts that require workers to join unions and pay dues as a condition of employment, effectively banning closed shops. A smaller share of workers join unions in right-to-work states—a boost for labor-market freedom.

Many of the states with the freest labor markets had low private-sector unionization rates in 2000-14—Virginia at 5 percent, Georgia at 5.1 percent, Texas at 5.25 percent, South Dakota at 5.6 percent. By contrast, union strongholds included the states with low labor-market freedom, topped by New York at 25 percent and Alaska at 22.7 percent.

Progress toward greater labor-market freedom isn't guaranteed. Advocates campaign for higher minimum wages, pro-union legislation and other interventions they claim will benefit workers. However, these measures erode labor-market freedom, so they're likely to lead to slower job growth and lower real after-tax wages.

Labor-market freedom benefits workers and contributes to a growing economy, but it rests on policies that state legislatures can change at any time. The risk to labor-market freedom has grown in recent years as more Americans worry about the plight of the middle class and widening income inequality. Labor-market interventions often seem like a quick fix, but the data suggests that workers will be better off with greater labor-market freedom.

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Next issue: The next chapter in *The Texas Economy's* series on state economic history will focus on technologies that led to the rise of cattle ranching as a major Texas industry in the years after the Civil War.

About the Authors

Michael Cox

W. Michael Cox is founding director of the William J. O'Neil Center for Global Markets and Freedom at Southern Methodist University's Cox School of Business. He is economic advisor to MPACT Financial Group.

Richard Alm

Richard Alm is writer in residence at the William J. O'Neil Center for Global Markets and Freedom at Southern Methodist University's Cox School of Business.

CHARTING THE TEXAS ECONOMY

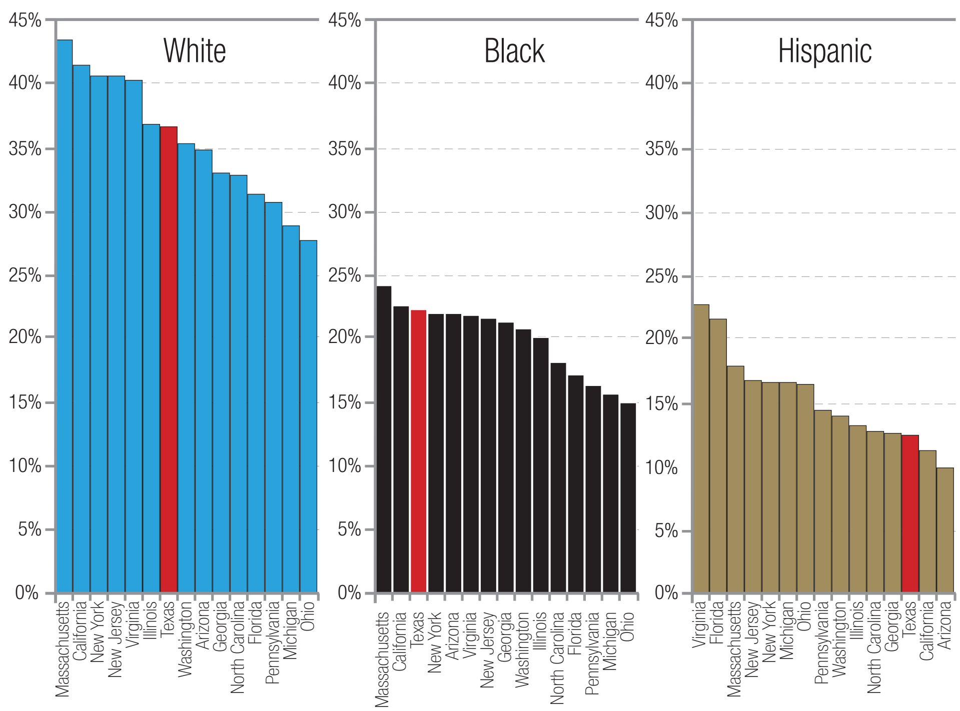
Ethnicity Key to Texas' Lag Behind Other States in College-Educated Workers

Knowledge-based industries provide high-paying jobs to educated workers. Among the 15 largest states, Texas ranks 14th in the share of population 25 and older with bachelor's degrees or higher.

The state's ethnic makeup helps explain the low ranking. Texas' white population ranks seventh in college degrees when compared to whites in the other Top 15 states, and Texas' black population ranks third (*see chart*). Texas' Hispanic population, however, ranks 13th.

Texas winds up 14th overall because Hispanics make up 38.4 percent of the state's population—highest among the Top 15 states.

In addition, states with more highly educated Hispanics tend be those that don't border Mexico. First generation Hispanic immigrants often enter the United States via Texas, California, Arizona and other southern states. Later generations tend to receive more education, and they're more likely to live in other states.



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The Texas Economy is an electronic publication of the William J. O'Neil Center for Global Markets and Freedom, a research institute in the SMU Cox School of Business.

The center was founded in 2008 with an initial grant from William J. O'Neil, a 1955 SMU business school graduate, and his wife Fay C. O'Neil. Its broad mission is the study of why some economies prosper and others do poorly, focusing on two critical issues for the 21st Century economic environment—globalization and economic freedom.

The center's programs promote understanding of how capitalism works among the general public, policy makers, business managers and the next generation of business leaders. To these ends, the O'Neil Center teaches SMU Cox students, conducts economic research, publishes economic reports, sponsors conferences and educates the public through the media and speeches.

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