Which Way, America?

Economic Freedom or the Road to Serfdom

2011 Annual Report • O'Neil Center for Global Markets and Freedom • SMU Cox School of Business

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The William J. O'Neil Center for Global Markets and Freedom 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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A Message from the Dean

In the fall semester, I had the great privilege of returning to the classroom to teach a newly developed course called the Evolution of American Capitalism. It gave me an opportunity to explore this country's long and winding road from subsistence farming to post-industrial colossus. I also had to confront some of the unsettling realities of today's economy—most important, the huge loss of jobs and the slow rebound of employment opportunities.

The classroom was filled with bright and energetic young men and women, the kind of students we see so often here at the Cox School of Business. Their eagerness to learn and tackle great challenges was palpable, but I wondered whether our battered and debt-sodden economy would provide them with opportunities for great careers.

My concern for our students' futures gives me a personal stake in the essay Michael Cox and Richard Alm wrote for the O'Neil Center's third annual report. They ask a question sure to reverberate as this year's election campaign goes forward: *Which Way, America?* The title captures the choice that lies before us—the prosperity that comes with greater economic freedom or the decline that comes with the drift toward bigger government.

I hope we take the right road and choose greater economic freedom.

While the election makes the essay timely, some of its basic themes are timeless. Incentives are powerful—so get them right. Choices have consequences—so make good ones, both as individuals and as a nation. Economic freedom creates productive incentives, fosters good choices and rewards success—so it's important for America's economic future.

Texas' job growth and business climate insulate us from the country's economic ills. But I've spent a good deal of time in other states, talking about the U.S. economy with SMU Cox alumni and other people on the front lines of American business. They're bewildered. They're searching. After reading this essay by Cox and Alm, they'll have a much better idea of what's gone wrong and how to fix it.

Albert W. Niemi, Jr.
Dean, Cox School of Business

Which Way, America?

Economic Freedom or the Road to Serfdom

By W. Michael Cox and Richard Alm

American capitalism has delivered generation after generation of economic progress. The descendants of hardscrabble farmers who plowed the fields from dawn to dusk are today working in air-conditioned offices and driving minivans, living in spacious homes, shopping at overstuffed malls, taking Caribbean cruises and video-chatting on their iPads.

We owe our high living standards to economic freedom, with its reliance on market incentives that encourage us to work, save, invest, innovate, start businesses and take risks. Our free-enterprise system favors production over taxes and handouts, responsibility over dependence and opportunity over equality. The rewards have been progress instead of decline, wealth instead of poverty.

America's past success only adds to the frustration with today's economy. One calamity has followed another—an epic housing bubble burst, a financial crisis staggered the economy, a long and deep recession gave way to a balky recovery, with new jobs coming at a snail's pace. Middle class families struggled as government lavished trillions of dollars on bailouts and handouts, pushing the country deeper into debt.

A growing number of Americans view today's economic troubles as evidence that we've lost our way. They're frightened by a bigger and more intrusive government. They're angered by the forced equality of redistributionist schemes that focus on divvying up the existing pie rather than baking a larger one.

They're dismayed by a cynical populism that mocks the good choices of successful individuals and reduces so many others to dependence on government. They see taxes punishing hard work and sacrifice, opportunism replacing opportunity. They warn these policies will condemn America to decline instead of progress, to poverty instead of wealth. They know we're on the road to serfdom.

The words should have a familiar ring. Written nearly seven decades ago by Austria-born economist Friedrich Hayek, *The Road to Serfdom* presaged the stark choice facing the United States today: The prosperity that comes with greater economic freedom, or the economic privation that lies in greater government control of the economy.

Which way, America? The direction we choose will determine the kind of country we leave to our children and grandchildren.

Two Economic Systems

Hayek's book compares two ways of running an economy—one dependent on government fiat, one guided by markets. Socialist and capitalist systems differ starkly on the fundamental choices of economic life—what to produce, how to produce it, how much to work, what each person gets to consume *(see Box 1: Capitalism's Lonely Prophet)*.

The despots who imposed Soviet-style central planning have been tossed into the dustbin of history, but socialism survives in the form of overbearing elites wielding immense power in offices, agencies, ministries, commissions and bureaus. Today's less totalitarian socialism tolerates the private sector, but saddles business operators with a not-so-silent partner, who butts into decisions about product design, production methods, output, wages, working conditions, prices and profits. Protecting jobs and promoting social goals take precedence over producing, innovating and competing.

Consumption comes as a right, not as a reward for work. Government subsidies cover housing, food, health care, transportation, college education and pensions—so individuals have

BOX 1

Capitalism's Lonely Prophet

Friedrich Hayek was born in Vienna in 1899. After serving as an artillery officer in World War I, he returned home to study at the University of Vienna, one of the world's great intellectual centers. Hayek gravitated to the classical liberalism espoused by Carl Menger and Ludwig von Mises.

Hayek's notoriety grew after he moved to the London School of Economics in 1931, becoming the pre-eminent proponent of the Austrian School, which champions free markets as the most productive and just way to raise society's living standards. In the 1930s, Hayek's belief in markets led him into an epic intellectual battle with John Maynard Keynes, the most famous economist of the times. Hayek disputed Keynes' contention that government spending would lift Britain and other countries out of the Great Depression.

Hayek published *The Road to Serfdom*—his most widely read book—in 1944, when capitalism's standing was at a low ebb. After the Depression and war mobilization, intellectuals and politicians had embraced Keynesian economics and the idea that government planners were better than markets for running an economy. Hayek offered a forceful voice of dissent, making reasoned arguments in favor of markets while pointing out the inherent flaws in central planning.

The Road to Serfdom made Hayek an intellectual hero to those who embrace the cause of economic freedom—including Ronald Reagan in the United States and Margaret Thatcher in Britain. Smuggled translations of the book kept the flame of economic freedom alive behind the Iron Curtain, contributing to the demise of communist rule.

In 1950, Hayek moved to the United States, where he joined the faculty of the University of Chicago before moving on to other institutions and eventually returning to Europe. Throughout his career, he continued his scholarly writings, producing books that examined the role of government in a free society, such as *The Constitution of Liberty* in 1960 and *Law, Legislation and Liberty* in 1973.

In 1974, a scholar who had for decades been an an outsider in a profession dominated by Keynesian orthodoxy won the Nobel Memorial Prize in Economics. Hayek died in 1992.

little reason to put forth an effort to produce. Somebody else will pay the bills. In fact, socialist systems' incentives are all bad—work as little as possible, vote for bigger handouts, protest any attempts to reduce government spending.

An economy that works as little as possible will atrophy, its labor idle while output spirals downward. An economy that consumes more while producing less will descend into poverty. An economy that grows poorer will resort to the power of government to force its citizens to work. And, surely as day follows night, it will arrive at a final destination—the poverty and tyranny of serfdom.

Economic freedom takes us to a better place. In market-based systems, governments protect property rights and provide necessary public goods, but companies and individuals are free to decide how best to produce and consume. Their buying and selling generate market signals—prices, wages, profits and rates of return.

These signals shape the autonomous decisions on what to produce and consume. From millions of producers and consumers, most of them completely unknown to each other, markets forge a spontaneous order that lifts living standards.

Getting so many diverse and disconnected individuals to work together for the common good is no small feat. Yet, markets do this so routinely and so well in America that we take them for granted. We simply assume that gasoline will be there when we pull up at the pump, or that 30,000 items will be waiting on our supermarket's shelves.

All exchange is voluntary, so producers prosper only if they sell goods and services that meet consumers' needs at reasonable prices. How much you produce determines how much you consume—a clear incentive to work. Without the link between production and consumption, socialist systems are dysfunctional. With it, free markets encourage workers, companies and investors to undertake the productive activities that grow the economy.

Markets steer us on the right course. Just as important, they tell us when we're on the wrong course. Producers compete for customers. Failing to meet consumers' needs or setting prices too high will lead to lost sales, falling profits, job losses and even bankruptcy. Market feedback provides incentives to correct mistakes quickly, reducing waste and inefficiency. By rewarding success and punishing failure, capitalism recycles resources from those who don't use them well to those who do. Society gains with higher living standards.

The dichotomy between socialism's failure and economic freedom's success isn't a matter of esoteric economic theory. The United States left decisions on production and consumption largely to the private sector—and ended up the world's richest nation. In the Soviet Union, Communist Party apparatchiks ran a corrupt, brutal and woefully inefficient system—until it collapsed in 1991.

China remained poor through centuries of feudalism and decades of communism; just three decades of capitalist reforms brought stunning economic progress. A jolt of capitalism put India's long-struggling economy on a path to faster growth, too.

Both North and South Korea were poor and prostrate at the end of World War II; 65 years later, the authoritarian North struggles to feed itself on a per capita income of $1,800 a year, while the market-oriented South created one of the post-World War II era's economic miracles, raising its per capita income to $30,000 a year.

Recent events reinforce the importance of the choice between socialism and economic freedom. After joining the European Union, Greece began living on government handouts, paying for it with borrowed money. Choosing plunder over production, Greece sank into a debt crisis that drove the nation's per capita GDP down more than 14 percent in just three years.

Within the United States, government-heavy California has been losing population and employment, while Texas' market-friendly policies led to more in-migration and job creation than any other state.

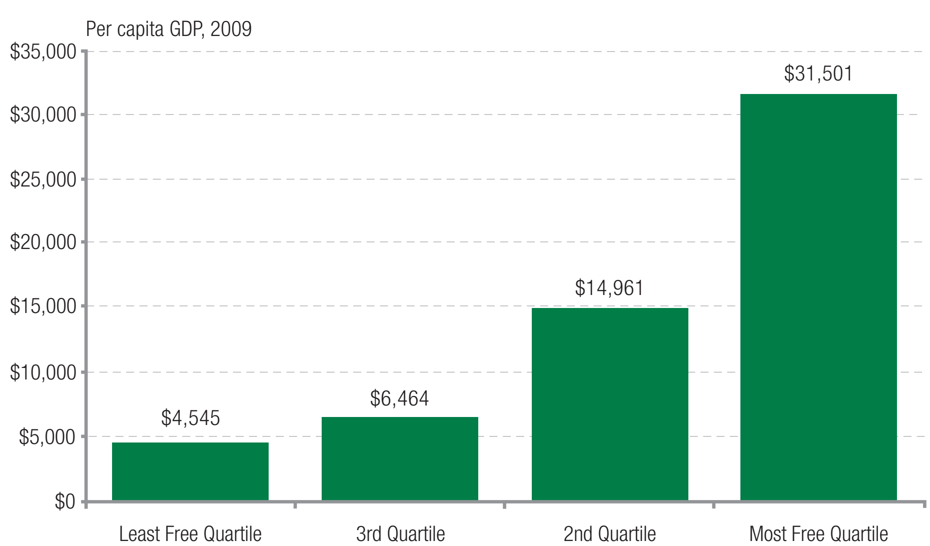
The *Economic Freedom of the World* report leaves no doubt about which economic system works best. Among the 141 nations covered, the quarter with the greatest reliance on economic freedom and markets churned out an average of $31,501 per capita in 2009. By contrast, the bottom quarter with the most authoritarian economies produced a paltry $4,545 in output *(Exhibit 1)*.

Why the yawning gap? Economic freedom gives us motive and opportunity to apply ourselves in the cause of production. The pie grows. Where incentives to produce are nil, efforts turn to plunder. The pie shrinks.

EXHIBIT 1

Economic Freedom Pays Off

Nations in the top quarter of the *Economic Freedom of the World* report have an average per capita income that is double the countries in the next quartile—and seven times greater than those in the least-free grouping.



What Markets Tell Us

> **"It is only because the control of the means of production is divided among many people acting independently that nobody has complete power over us."**
>
> **— Hayek, *The Road To Serfdom***

Hayek, Milton Friedman and their followers described how free-enterprise systems create powerful and consistent incentives to guide the everyday decisions that generate economic growth and prosperity—for individuals, for states and for nations.

How long we stay in school, what we study, where we work, how hard we work, what we buy, how much we save, where we invest, what businesses we start, how many workers we hire and the risks we take—these are the choices we face. Markets lead us to make the right ones.

For example, markets tell us something important about education. Earnings rise sharply with additional years of schooling. American high-school dropouts aged 25 to 34 earned an average of $26,000 in 2009. For the same age group, a bachelor's degree raised earnings to $63,000. Staying in school to get a professional degree lifted average income to $126,000 *(Exhibit 2, top)*. The market signal could hardly be any clearer—stay in school.

The payoff from education grows as Americans age and gain experience. Workers aged 45-54 with bachelor's degrees made roughly $37,000 a year more than those with the same education level in the 25- to-34-year-old age cohort. An even bigger premium comes at the top of the educational ladder, among workers who earned doctoral and professional degrees. Once again, markets are sending a strong signal—continue to learn over your lifetime.

Markets tell us another thing about education—what we study matters almost as much as years of schooling. In 2010, graduates with bachelor's degrees in petroleum engineering started work at a median pay of $93,000 a year. Majoring in chemical engineering, computer science, civil engineering, physics and statistics also led to relatively high starting pay *(Exhibit 2, middle)*.

By contrast, graduates with bachelor's degrees in English, music, sociology, journalism, theology, art and social work commanded median pay of less than $40,000 a year. Through pay variations, markets are signaling that the economy puts a higher value on some fields than on others, giving students a guide for what to study.

Markets tell us that individual job performance matters. Within disciplines, mid-career salaries vary widely among U.S. college graduates. Workers with bachelor's degrees in economics, for example, earn $50,000 at the 10th percentile, $100,000 at the median and more than $200,000 at the 90th percentile. For math majors, the range is $45,000 to $180,000. The income gap is smallest in nursing, education and other fields—but it persists across the board *(Exhibit 2, bottom)*. Markets give us the right signals—work hard on the job, hone our skills and look for opportunities to display exceptional abilities.

Through rewards for staying in school and working hard on the job, markets give individuals clear incentives to engage in productive activities. The same applies to saving and investment, both key factors in economic growth and job creation. By offering high private-sector rates of return and profits, markets tell us to finance enterprises that deliver what consumers want at the lowest cost.

Using 1925 as the starting point, investing in the private sector has delivered strong annual real rates of return—8.8 percent for small-company stocks, 6.7 percent for large-company stocks and 2.8 percent for long-term corporate bonds. Adjusting for inflation, for example, a dollar put in small-company stocks in 1925 would be worth $1,313 in 2010 *(Exhibit 3)*. A similar stake in big companies would have grown to $243.

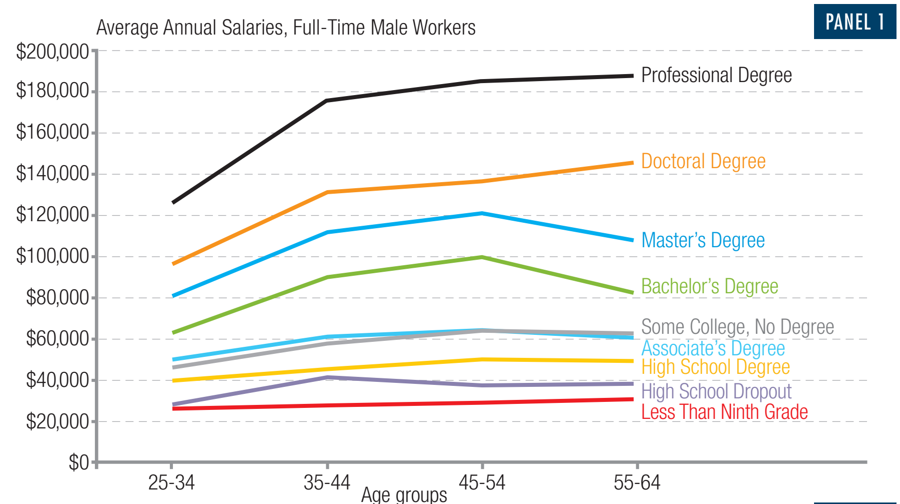
The market's incentives aren't as bullish for less-risky government debt—2.4 percent for long-term bonds, 2.3 percent for intermediate issues and 0.6 percent for short-term Treasury bills. Gold, the investment of choice for iffy times, performs more like government bonds than equities.

Not all private-sector investments pay off. Some companies may languish or even fail—but that's the risk investors willingly take in exchange for higher expected rates of return. With risk must come reward—or else the risk won't be taken, the businesses won't get started, the workers won't get hired and the economy won't grow.

EXHIBIT 2

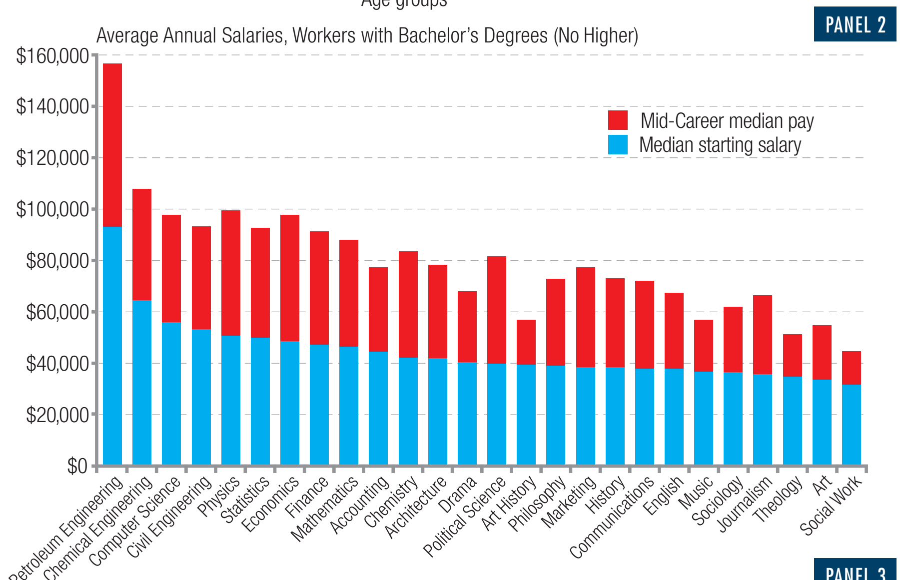
'Led By an Invisible Hand'

In *The Wealth of Nations* Adam Smith stresses the power of incentives, proclaiming that by making ourselves better off we're "led by an invisible hand" to make others better off, too. More than two centuries after Smith fashioned this indelible image, U.S. labor markets offer strong incentives to …



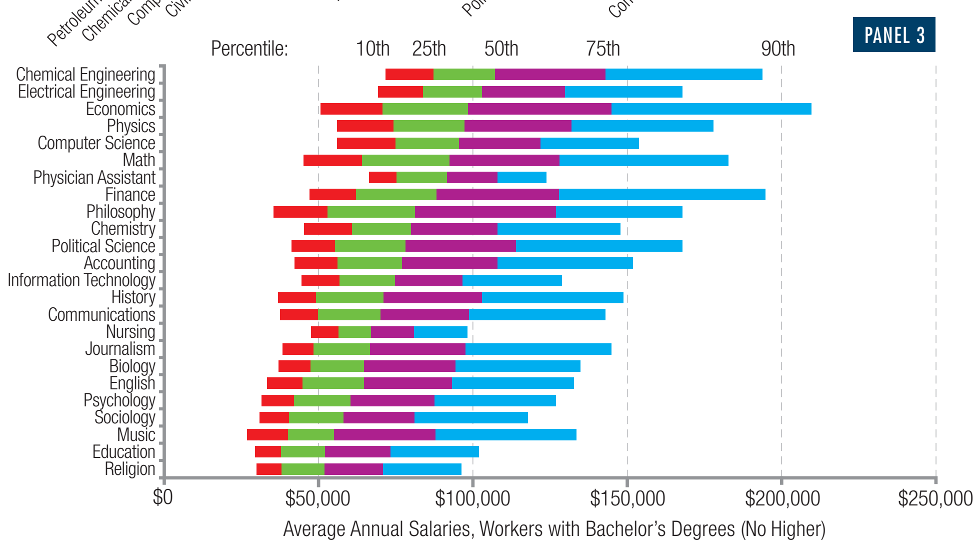
… Get an Education

Average annual incomes rise as U.S. workers climb the educational ladder–without exception. Graduates with doctorates and professional degrees earn the highest pay. Finishing college with a bachelor's degree yields a healthy premium over a high school diploma. High school dropouts usually end up with lower paying jobs. Better educated workers earn more because they are more productive.



… Choose Highly Valued Fields

Employers are willing to pay more for workers with the most productive knowledge. Higher pay encourages students to study such difficult subjects as engineering, computer science, physics, economics and finance. On average, graduates in sociology, journalism, theology, art and social work settle for lower-paying jobs. The pay gaps widen as workers move up from their entry-level jobs.



… Work Hard to Get Ahead

Wages vary widely within professions, reflecting individual skills and motivation. Among college graduates at mid-career, top-tier employees can earn two to three times more than their profession's lowest-paid workers. The pattern persists across all fields, suggesting markets routinely reward those who work harder, hone their skills and become more productive on the job.

Markets tell us to invent, innovate and start businesses. Technology drives economic progress, but for most of history it moved forward at a snail's pace. Capitalism brought an epochal transformation, igniting a burst of technological change that continues to this day. It's a matter of incentives. The system generates profits to those who come up with new and better products, more efficient methods of production and better ways to serve consumers.

The process of technological change fuses the vision and energy of several American archetypes. Inventors see what could be. Innovators improve what is. Entrepreneurs spot profit potential and organize businesses. Capitalists finance the new ventures. In American history, they've all come together time and again to build our economy with steam engines, electricity, telephones, radios, automobiles, airplanes, elevators, refrigeration, televisions and so many other innovations that improved our everyday lives.

An example of technology powering progress centers on one of the most revolutionary inventions of recent times—the microprocessor, the miniature circuits that power electronic devices. Since the early 1970s, increasingly powerful computer chips have revolutionized the way we process, store and transmit information. Entrepreneurs introduced a mind-boggling array of new products based on the microprocessor—computers, the Internet, software, iPhones, digital cameras, DVD players and so much more.

All told, the economic activity based on the computer expanded from $164 billion in 1977 to $1.6 trillion three decades later *(Exhibit 4)*. This surge

EXHIBIT 3

Rewards for Taking Risks

Through higher rates of return, capitalism gives investors incentives to finance private companies that grow the economy and create jobs. After inflation, $1 invested in 1925 would yield far more in stocks than in corporate bonds, government debt or gold.

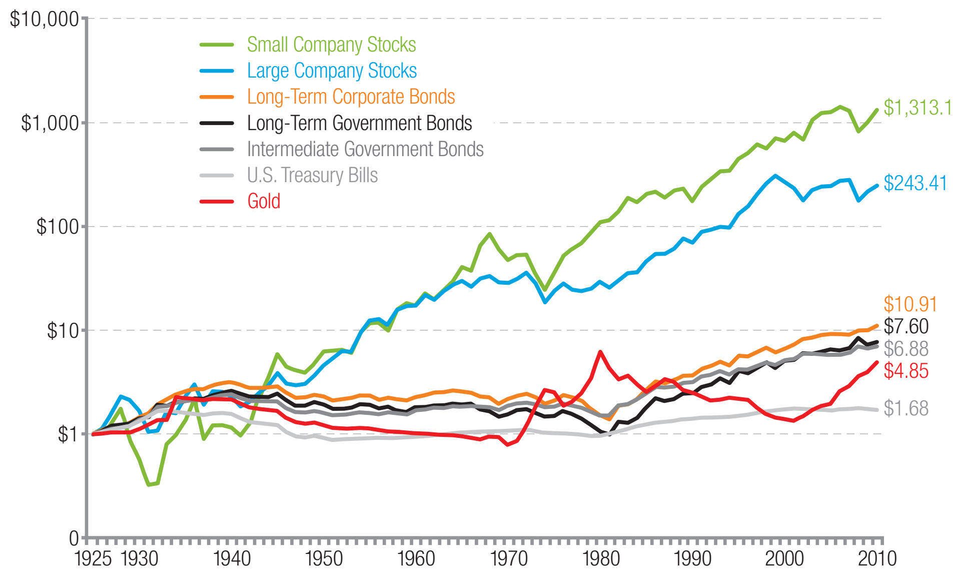
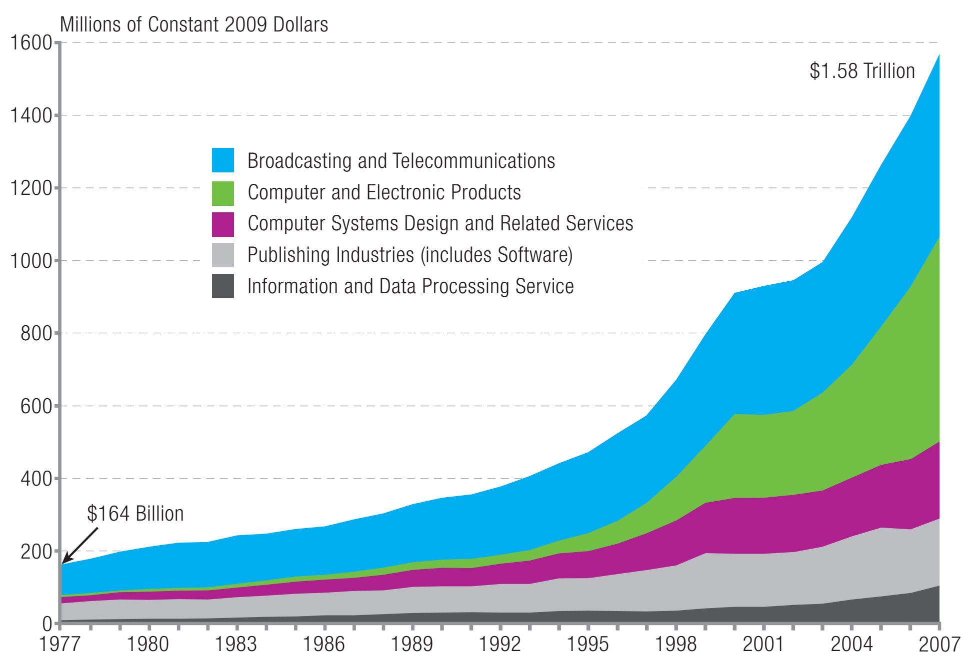


EXHIBIT 4

Entrepreneurs Drive Growth

The arrival of the microchip in the early 1970s fueled growth for the U.S. economy. The economic value of computer-related industries grew tenfold in just three decades, becoming a $1.6 trillion industry.



in just one sector added nearly a half percentage point to the nation's annual growth rate.

Without the microprocessor and its associated innovations, Pierre Omidyar couldn't have launched eBay for online auctions. Larry Page and Sergei Brin couldn't have created Google, the pioneering search engine. Jeff Bezos couldn't have been able to become the kingpin of online retailing with Amazon.com. Mark Zuckerburg couldn't have connected millions of people via Facebook. Taken together, these four Internet era success stories are worth about $400 billion and employ more than 106,000 workers.

Time and again, American capitalism has performed this bit of alchemy, turning ideas and initiative into pure gold. Immense wealth has been created across telecommunications, entertainment, finance, pharmaceuticals and other sectors. However, economic freedom

BOX 2

History's Greatest Anti-Poverty Program

The United States has the world's richest poor people. Today, families classified as poor are very likely to consume the goods and services that just a generation or two ago were the hallmarks of the sturdy American middle-class.

At least 90 percent of households below the poverty line own a refrigerator, color TV, stove, telephone and microwave oven. At least 80 percent have a vehicle, air-conditioning and the protection of a smoke detector; at least 60 percent possess a washer, dryer, cable or satellite TV and a VCR or DVR. More than half have computers and cell phones. Forty percent own their own homes. *(chart 1)*

A century ago, nearly all Americans were poor by today's standards. And we'd still be poor—if not for capitalism's everyday miracles. As companies strive for larger profits, relentless competition and innovation raise productivity and wages, driving down hours and minutes of work required to buy most goods and services.

Over various time periods, work-time prices have plunged more than 99 percent for long-distance phone calls, electricity and computing power. They've gone down more than 95 percent for cell phones, refrigerators, calculators, color TVs, contact lenses, air travel and dishwashers *(chart 2)*.

New products are usually expensive to develop, and at first only a few wealthy households can afford to buy them. As markets whittle down work-hour prices, the products spread across all rungs of society, reaching middle class and poor households. Throughout the 20th century, we saw this with telephones, electricity, cars, radios, household appliances and other products *(chart 3)*. In recent decades, the spread of products shows signs of accelerating, with cell phones, VCRs, computers and other gadgets becoming nearly universal in just a few years.

Capitalism's capacity to lift people out of poverty isn't limited to the United States. For two millennia, under state-dominated feudalism and communism, China's economy stagnated, its per capita income stuck at a paltry $500 to $800 a year. In the three decades after capitalist economic reforms, hundreds of millions of Chinese have risen out of abject poverty. The country's per capita income skyrocketed to more than $8,000 in 2010.

Before the economic reforms, the typical Chinese family owned next to nothing. Year by year, an increasing number of households were able to buy washing machines, dryers, vacuum cleaners, cameras, cell phones, computers, Internet access, cell phones and even cars *(chart 4)*.

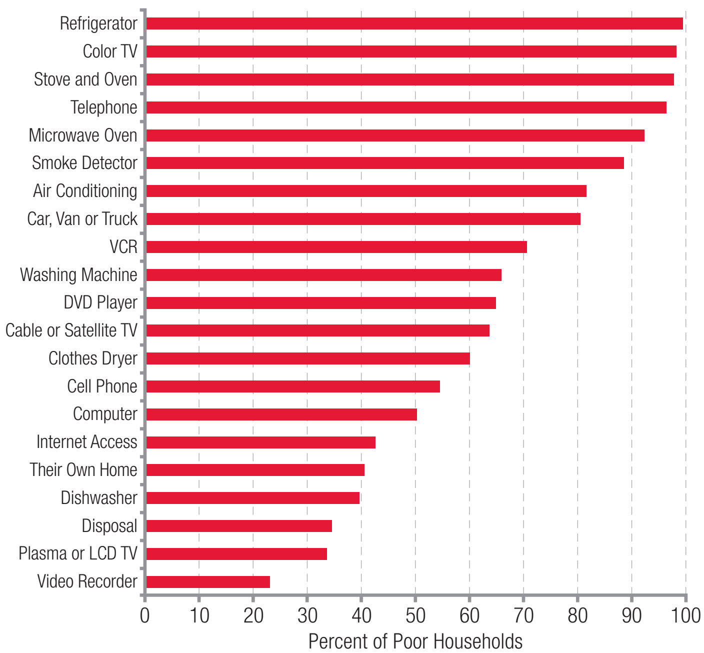
Big government apostles blame capitalism for poverty and clamor for redistribution and hand-outs to help poor families. In the 1960s, Washington declared a War on Poverty—but five decades and billions of dollars later we see the folly of an approach that stifles initiative and breeds dependency on government. Capitalism's defenders too often apologize for poverty. It's time they stopped. Economic freedom doesn't create poverty, it reduces it.

isn't just a gift to visionaries like Mark Zuckerberg. To the contrary, billions of ordinary people around the world have escaped the sting of poverty because of productive activity based on what markets tell us to do *(see Box 2: History's Greatest Anti-Poverty Program)*.

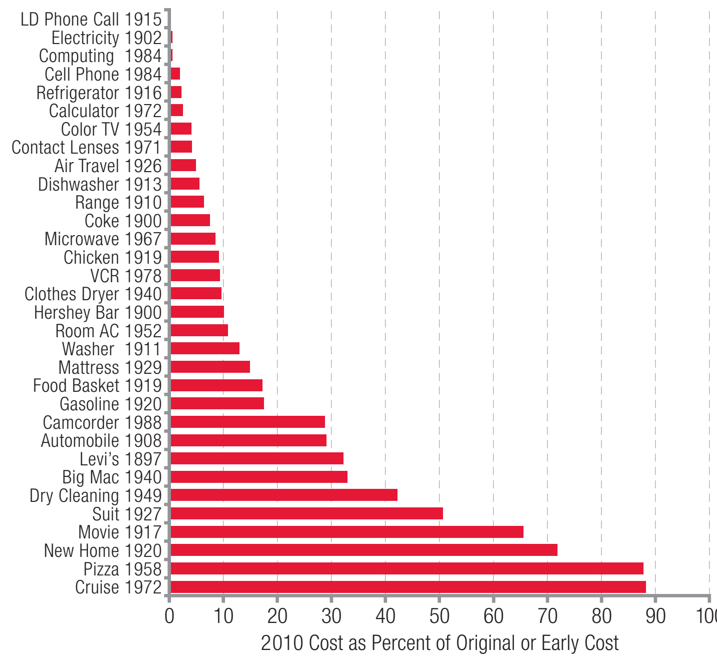
The success of free enterprise gives rise to a conundrum: Why do societies forsake economic freedom and take the road to serfdom?

Government tentacles worm their way into the economy through noble-sounding rhetoric—create jobs for the unemployed, help the less fortunate, make economic life fairer or safer. The resulting policies and programs almost always fail, but sales pitches full of good intentions obscure the naked self-interest at play in the political arena. Individuals, industries and interest groups seek to feather their nests with government favors, protections and income transfers. The

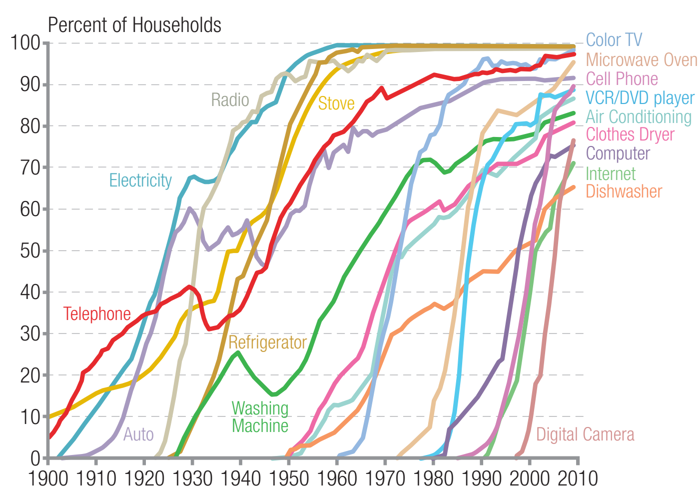
1. What American Poor Households Own



2. Making Goods and Services More Affordable



3. Spread of Products Into U.S. Households



4. Spread of Products Into Chinese Households

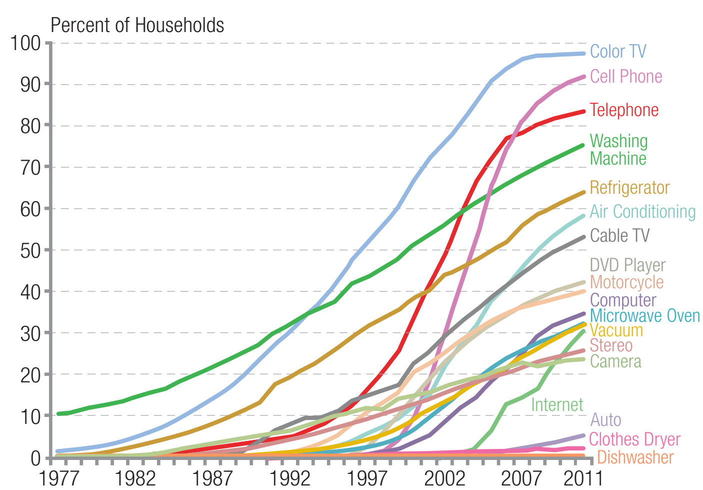


EXHIBIT 5

Income Taxes: The Rich Pay More

Discussions of the income tax raise issues of fairness: Who pays how much? Internal Revenue Service data disprove the popular belief that upper-income households are shirking. In fact, their tax burdens have risen sharply since 1980.

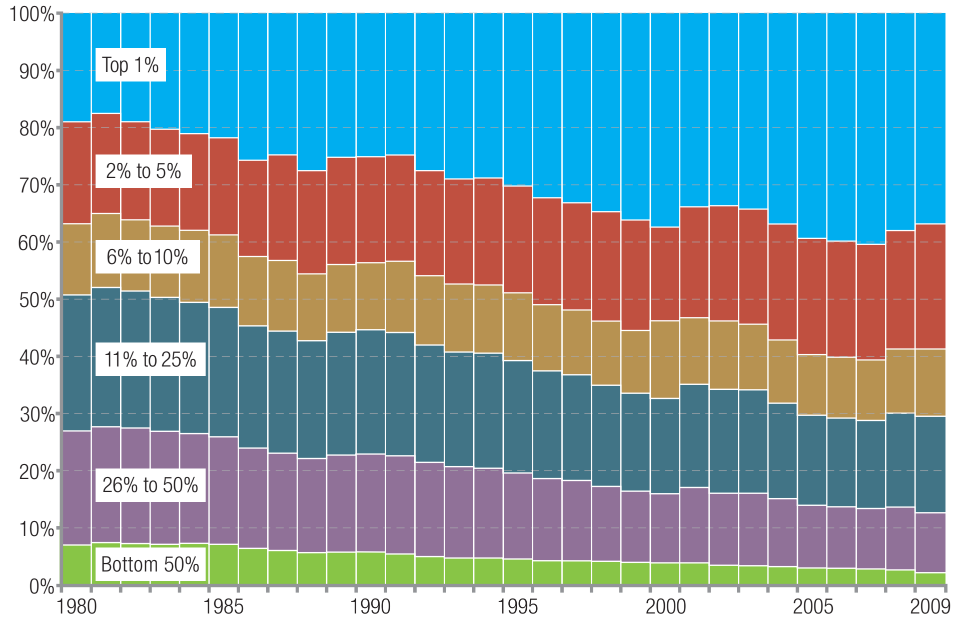
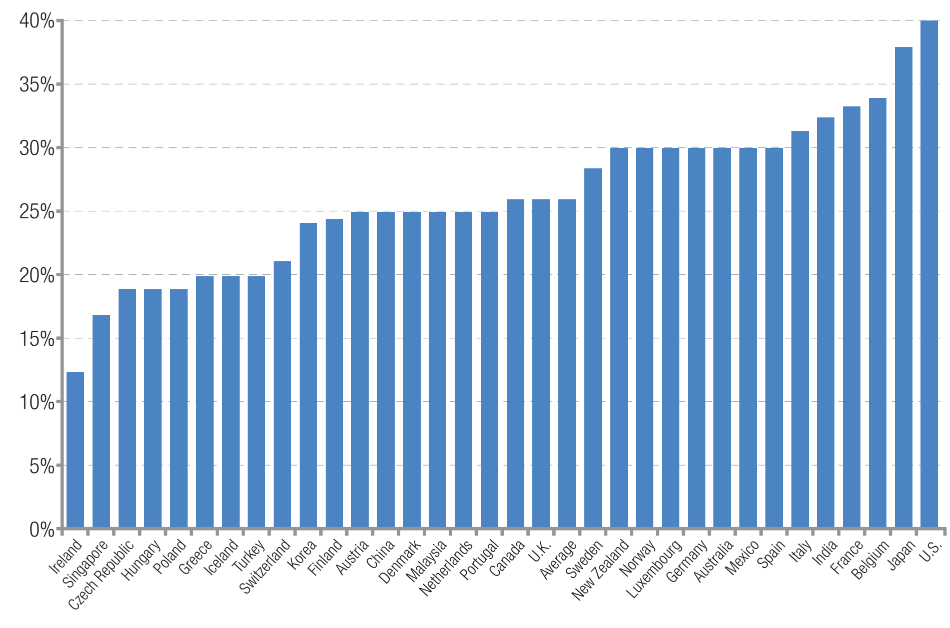


EXHIBIT 6

Penalizing Success in Business

Between 1996 and 2010, OECD countries cut their business income taxes by an average of 11.4 percentage points. Not the United States. Its rates stayed roughly the same, leaving the country with the developed world's highest corporate profits taxes.



politicians who deliver get their payoff in campaign contributions and votes.

Government actions to tax, spend, redistribute and regulate benefit some—but only at the expense of others. Political self-interest degenerates into a negative-sum game, dependent on coercion; it undercuts the positive-sum game of economic freedom and market self-interest. Bigger government weakens and distorts market incentives, imposing burdens on the productive activities that spur output and create wealth. The economic pie ends up smaller than it would otherwise be—to the detriment of society as a whole.

A Taxing Situation

Income taxes are pervasive in the United States. The Treasury takes up to 36 percent of every dollar earned, then imposes an added 15 percent to pay for Social Security, Medicare and Medicaid. All but seven states levy their own income taxes, and most big cities add to the burden. By the time all governments are done, the highest U.S. marginal income tax rates climb above 50 percent. Economists Robert Barro and Charles Redlick calculate the average marginal rate at about 35 percent.

Getting $65 of income for $100 of effort weakens incentives for productive activities. Reduced rewards for work make leisure more attractive, so we spend less time on the job or abandon the labor force altogether.

Through income taxes, governments erode the value of added years of schooling and make it less likely students will choose the harder courses of study that command higher pay. After-tax investment gains diminish, pushing households toward consuming more and saving less. Taking on the government as partner, entrepreneurs have less reason to endure the struggles and tribulations of starting new businesses.

Today, the federal income tax burden falls increasingly on Americans with the highest earnings. For households in the Top 1 percent in the income distribution, the share of taxes paid rose from 19 percent in 1980 to 37 percent in 2009 *(Exhibit 5)*. The Top 10 percent went from 49 percent to 70 percent, the Top 25 percent from 73 percent to 87 percent.

High incomes aren't happenstance. They reward people who heed market signals about working hard, staying in school, entering high-paying fields, investing in private-sector enterprises, starting businesses and hiring workers. High tax burdens on those at the top of the income distribution penalize doctors, dentists, lawyers, entrepreneurs, managers, entertainers, athletes, inventors, investors and others who deliver society's most highly valued goods and services.

These disincentives to productive economic activity argue strongly for lower taxes. In our times, though, a disgruntled class envy grips a nation facing enormous federal budget deficits—and that puts high-income households in the taxing cross-hairs.

A popular manifestation of the mood is the so-called Buffet Rule, which would impose a minimum 30 percent tax rate on households earning more than $1 million a year. By eroding the advantage given to long-term capital gains, the rule would only increase burdens on entrepreneurs and investors—a sure way to slow economic growth and leave us all poorer.

High corporate income taxes impose another drag on productive activity. Over the past 15 years, other countries have been cutting their rates; now, the United States has the developed world's highest marginal rate at 40 percent *(Exhibit 6)*.

Companies are more mobile than individuals, so they vote with their feet. America's high tax rates give companies incentives to move production and jobs abroad, boosting growth in other countries. U.S. multinationals created more than 2 million jobs abroad from 1999-2009, while cutting 3 million at home.

On a Spending Spree

Major wars aside, America's federal spending as a share of GDP stayed below 10 percent of GDP until 1917. In the early 1930s, attempts to fight the Depression pushed it above 20 percent. The country crossed the 25 percent threshold in the early 1950s and reached the 30 percent plateau in the late 1960s. We eclipsed 35 percent in the early 1980s. In the past three years, America has been more profligate than at any time since World War II—with federal spending jumping above 40 percent of GDP from 2009 to 2011.

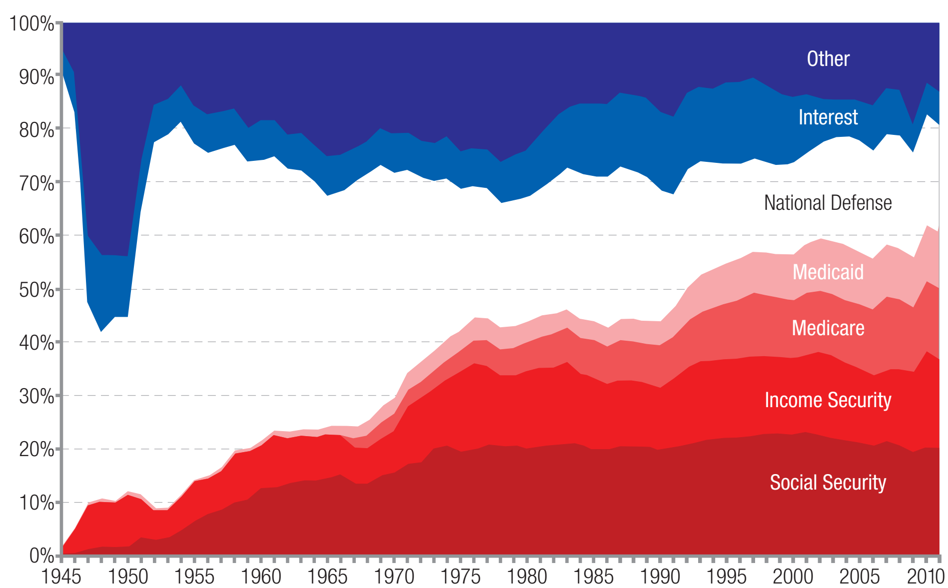
The huge expansion of federal spending stems largely from entitlements. Medicaid, Medicare, income security and Social Security have gobbled up an ever bigger share of the budget *(Exhibit 7)*.

Welfare cuts in the 1980s and reforms in the 1990s did little to slow the growth of means-tested programs. Heritage Foundation scholar Robert Rector counts 69 programs that aid low-income families, providing cash,

EXHIBIT 7

Tilting Toward Redistribution

Fueling growth in the size of government has been entitlements—payments to individuals under Medicaid, Medicare, Social Security and other programs (red). Entitlement spending as a share of GDP had never been above 12 percent until it topped 14 percent from 2009 to 2011.



food, housing, medical care, social services, training, and education assistance. Including state-level outlays, the tab ran to $927 billion in 2011. Social Security and Medicare outlays will balloon as Baby Boomers retire, and the federal government's massive health-care overhaul will hike government spending by at least $1.8 trillion by 2022.

Entitlements rupture the link between producing and consuming by subsidizing the living standards of some at the expense of others. In doing so, they reduce incentives to produce. Work isn't necessary. Not having to work erodes the rewards from education. Redistribution leaves

BOX 3

The Keynesian Seduction

Friedrich Hayek's great intellectual rival was British economist John Maynard Keynes, who argued that massive government spending could remedy insufficient demand. In the Great Depression of the early 1930s, the United States doubled government outlays relative to GDP. Unemployment didn't fall; instead, it jumped from 3.2 percent in 1929 to 25.2 percent in 1933—an outcome contrary to Keynes' doctrine.

Yet the policy's failure in the 1930s hasn't fazed Keynes' acolytes. They argue that U.S. policy was too timid and *even more* government spending was needed to cure the Depression. They point to World War II, where government spending rose from 20 percent to 50 percent of GDP and the unemployment rate fell to 1.2 percent.

Does this give Keynesians a good case? Hardly. To test the efficacy of stimulus, we look at the annual changes in U.S. government spending as a share of GDP from 1901 to 2011, measured relative to the growth trend of 1.76 percent. Then we determine whether the higher spending has lowered unemployment rates.

Only two periods of rising government spending have been associated with falling unemployment—1917-1919 and 1941-1945 *(see chart)*. They're both times of major world wars, where millions of adults were plucked from the civilian labor force to serve in the military. The share of the adult population on active duty rose from 0.3 percent in 1916 to 4.5 percent in 1918 and from 0.5 percent in 1940 to 12.3 percent in 1945. In short, unemployment fell not because of government spending but because of government conscription—hardly a good way to cure joblessness or evidence of a Keynesian miracle.

At nearly all other times during the 110-year sweep of U.S. history, government spending as a share of GDP and unemployment have moved in the same direction. It's true for the 1920s and the 1980-90s, when both were trending downward. It's true for the Depression decade, when both went up. And it's true for recent years, when spending soared and unemployment spiked.

Keynesian proponents could claim the positive correlation stems from increases in government spending to create jobs as unemployment rises. However, the pattern persists even with a lag, meaning that government spending programs have actually made the unemployed worse.

Keynesian-style demand stimulus assumes businesses receiving new orders will quickly go out and add workers. Why might firms not do that? First, they may regard the new demand as temporary and choose to squeeze more productivity out of the existing workforce rather than incurring the cost of hiring and training new employees. Output per employed worker rises during recessions, providing strong support for this notion.

Second, unemployed workers may lack the skills and training to perform the tasks newly demanded in business. This is particularly true when massive technological change makes the job skills of yesterday obsolete. Government programs that subsidize the unemployed only make the problem worse by enabling people to stay outside the workforce longer, individuals poor and unproductive, limiting their capacity to contribute to the economy and robbing them of their dignity. Income transfers hurt the economy while creating piles of public debt.

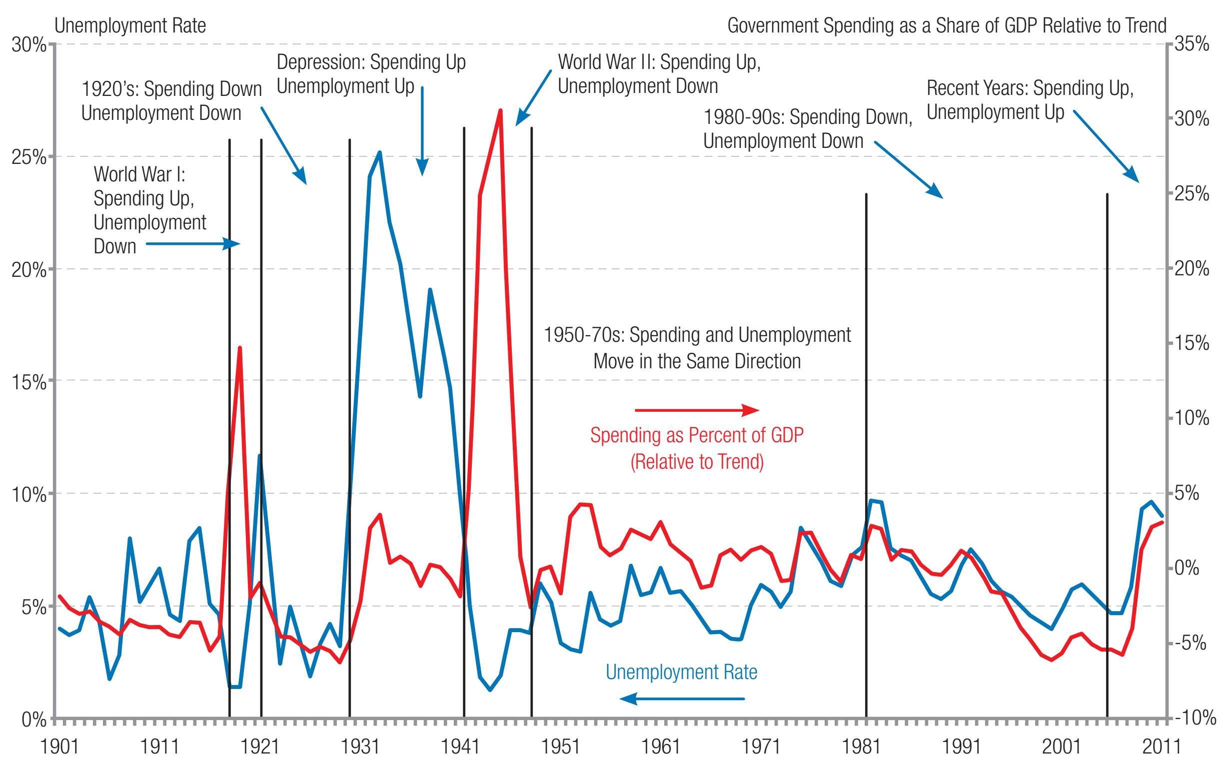
The same can be said for efforts to jump-start a struggling economy. On the surface, stimulus has intuitive appeal—put money in consumers' pockets, they'll start buying, then rising consumer demand will put the unemployed back to work as round after round of spending ripples through the economy. The idea's intellectual pedigree goes back to Britain's John Maynard Keynes, one of history's great economists.

where their skills atrophy or fall further behind the needs of the new workplace.

Third, more government spending ultimately means higher taxes. Many households will prepare to meet their future obligations by saving more and consuming less. So government spending crowds out private spending, negating policy-makers attempts to increase overall demand.

Fourth, and perhaps most important, demand stimulus doesn't create jobs. Firms are in business to make a profit, not to increase employment. They'll add workers only if it's the profitable thing to do. If salary plus benefits are too costly, the firm will not hire. Too often, taxes and government-mandated benefits saddle firms with substantial hiring costs, blocking the incentive to hire people to meet any demand, permanent or transitory. In short, demand doesn't create jobs, incentives do. Nothing in massive government spending addresses incentives to hire. Stimulus is doomed to fail.

More Government, More Unemployment



"We have progressively abandoned that freedom in economic affairs without which personal and political freedom has never existed in the past."

— Hayek, *The Road To Serfdom*

The policy prescription gains respectability from the popular misconception that President Franklin D. Roosevelt's deficit spending cured the Great Depression of the 1930s. It didn't. The economy just floundered as the 1930s wore on. Since then, some form of stimulus has been tried just about every time the U.S. economy has stumbled—and the results have been dismal *(see Box 3: The Keynesian Seduction)*.

Japan's plight gives clear testimony to the Keynesian failure. After the country's fast-growing economy slowed in the late 1980s, Japanese politicians unleashed torrent after torrent of stimulus in hopes it would eventually work. All the country got was massive debt and three lost decades with no growth.

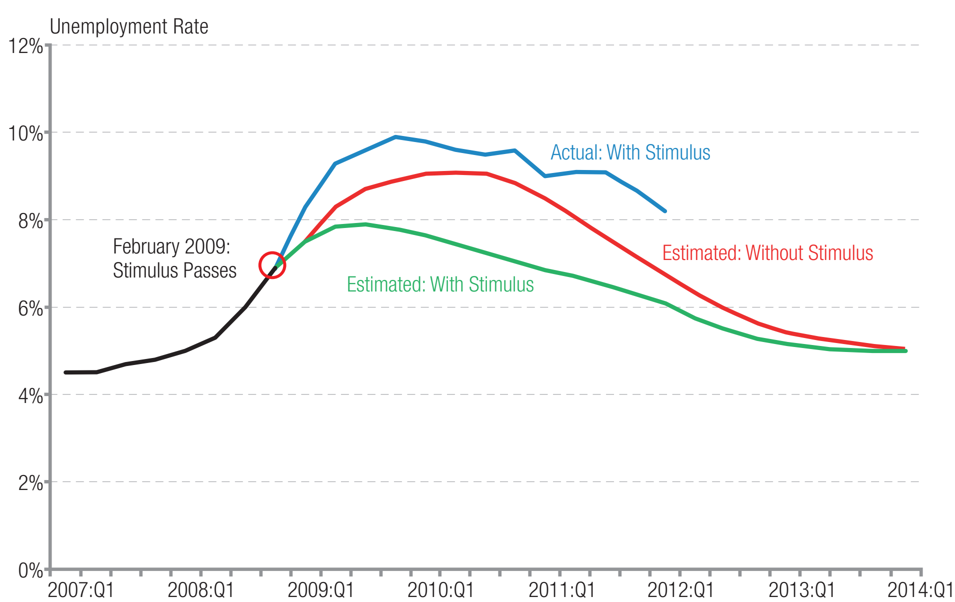
Although it's failed time and again, Keynesian stimulus gives politicians an occasion to do what they love most—spend money. And spend they did after the U.S. economy tanked at the end of 2007. In 2008, Congress approved $700 billion for sick financial institutions—and, it turned out, ailing automakers. An $825 billion stimulus package, passed in February 2009, authorized spending for infrastructure, health care, education, energy efficiency, scientific research and dozens of other projects. Rebates and tax cuts sought to rouse skittish consumers. Special programs sought to help Americans buy cars and new homes; other initiatives aimed at reducing foreclosures.

Once again, Keynesian policies didn't deliver. In January 2009, the future chairwoman of the Council of Economic Advisors said the stimulus would keep the jobless rate below 8 percent. While government went on its spending spree, unemployment kept rising, peaking at 10 percent in October 2009. After three years of stimulus, funded with borrowed money, unemployment hadn't yet gone down to 8 percent *(Exhibit 8)*. Big government made matters worse, not better.

EXHIBIT 8

Unstimulating Stimulus

In 2009, stimulus proponents said more government spending would lower U.S. unemployment. Instead, unemployment rose above what they thought it would be with no stimulus at all. Practice proves more than theory. Keynesians were wrong.



Another Keynesian policy failure hasn't led to a reappraisal of the belief that spending can solve the economy's problems. To some, the slow recovery means that the stimulus wasn't strong enough, or the economy was in worse shape than anyone thought. Neither argument faces the glaring truth—Keynesian stimulus doesn't work the way its adherents say it does.

Meddling in the Market

Taxes and spending aren't the only ways to use government compulsion to achieve outcomes contrary to the market's voluntary cooperation. In America today, a great deal of time, effort and money goes into the quest for tax breaks, subsidies and regulations that benefit special interests at the expense of the rest of us.

Energy policy provides a good

> **"The more we try to provide full security by interfering with the market system, the greater the insecurity becomes."**
>
> **— Hayek, *The Road To Serfdom***

example. In recent years, market incentives have given the United States cheap, growth-generating natural gas; at the same time, federal policy has lavished subsidies on more expensive wind and solar power. Two years after the Department of Energy guaranteed $535 million in loans to California's Solyndra Corp., the solar-panel manufacturer went bust, leaving taxpayers to foot the bill.

It happens over and over again. Government usually fails when it tries to pick winners, and it ends up costing us more than money. These policies destroy the market signals and incentives Hayek recognized as essential to progress.

Advocates of bigger government prey on fears to extend their dominion over the marketplace. After a few dozen rogues filed fraudulent financial statements, the government responded with the Sarbanes-Oxley law in 2002. While it may have cleaned up some abuses, the law imposed significant compliance costs, raised barriers to going public and reduced the global competitiveness of U.S. financial markets. The vast majority of publicly traded companies submit accurate accounts; under Sarbanes-Oxley, all American businesses will pay in eternity for the sins of a few.

Interfering in markets often takes a huge economic toll. The financial crisis that paralyzed the U.S. economy in 2007-08 had its origins in a decades-long government push to expand homeownership among low-income households. Subsidies, regulations, tax breaks, and loan guarantees fueled the subprime-mortgage excesses and housing bubble. Then government came to the aid of troubled financial institutions, reducing incentives for prudence in risk assessment and encouraging reckless lending.

The financial crisis created another excuse for new regulations on business. The Dodd-Frank legislation of 2010, a 2,314-page monstrosity, extends federal control over the already heavily regulated financial industry. Regulators are still haggling about how to implement Dodd-Frank—four years after the financial crisis. Reserve requirements and other key aspects of banking regulation remain in limbo, creating uncertainty that stifles the lending today's economy needs to grow.

An even worse job-killer looms in the complex health-care legislation slated to take effect over the next few years. If left unchanged, it would raise taxes, impose added costs on businesses and push the cost of insuring low-income workers onto the public sector. All firms employing 50 or more workers will be required to pay for health care—an obvious incentive to forego efficiencies of scale and keep companies small.

Politicians laud the benefits of government actions, but their meddling harms the economy by muddying the price signals that govern production and consumption. The intrusions lead to waste, inefficiency and pork-barrel projects. They impose unnecessary costs that hobble productivity, competitiveness and economic growth.

Distorted price signals sometimes set up perverse incentives that encourage producers and consumers to do things even the government doesn't want. The public interest often loses out. Industries have a huge stake in shaping the regulatory environment—so it's not surprising that lobbyists work to reduce competition and protect entrenched interests.

The regulatory explosion rests on the delusion that government knows better than the market. The political process doesn't operate with the market's self-correcting feedbacks—so bad policies don't lose favor or fade away, they persist and often keep growing. If a program or policy fails, advocates clamor for spending more on it.

Government's perverse incentives and stubborn refusal to face the reality of failure encumbers us with an ever-expanding bureaucracy that takes over more of our lives.

On the *Economic Freedom of the World* report, the U.S. scores have been falling for a decade *(Exhibit 9)*. The loss of economic freedom coincides with ominous signs of economic decline. Emerging from recession, businesses have been weighed down by the burdens and uncertainty of recent economic policies—so they haven't had the normal incentives to hire new workers.

As a result, job creation has been agonizingly slow, trailing all previous post-World War II slumps *(Exhibit 10)*. While the private sector has been languishing, the federal government has continued on its path of reckless spending. Stimulus' failed to jump

EXHIBIT 9

Heading the Wrong Way

The United States began the 21st Century as a paragon of economic freedom. Since then, its score on the annual *Economic Freedom of the World* report has declined sharply. The United States fell to 10th in the world in 2009—behind such culturally similar countries as New Zealand, Canada, Australia and Great Britain.

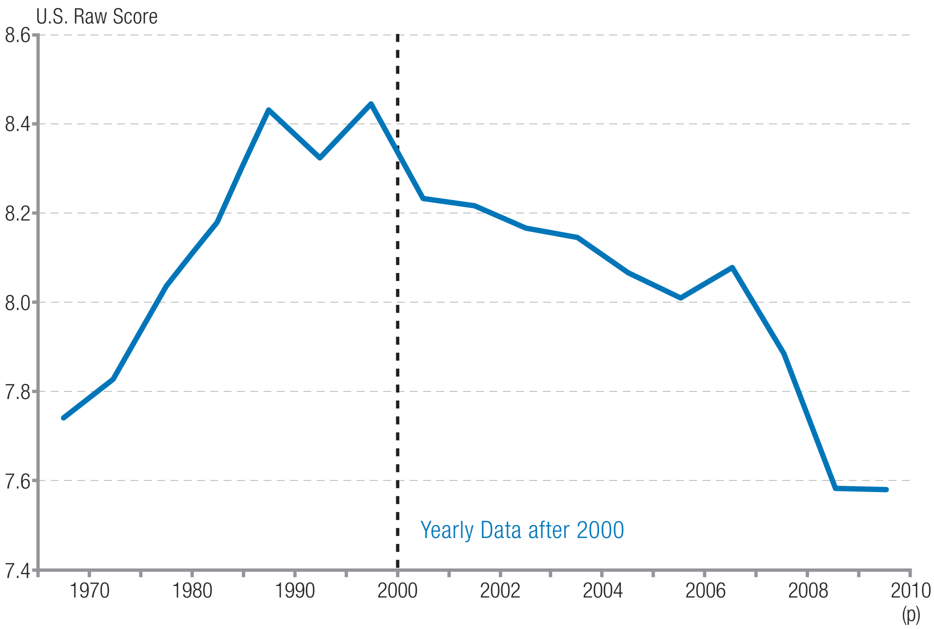
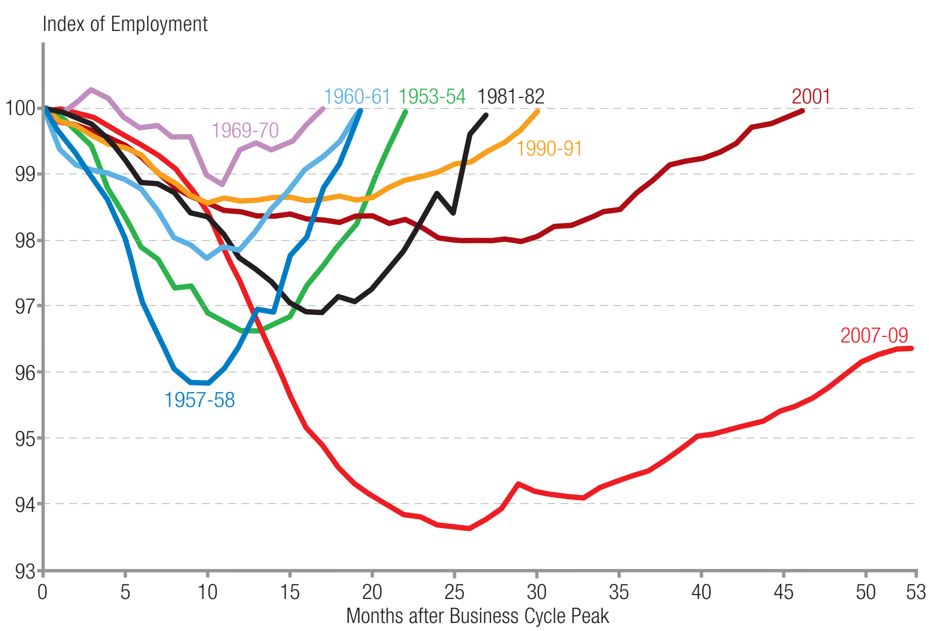


EXHIBIT 10

An Economy Adrift

The recent recession's job losses far exceeded the employment declines of previous post-World War II recessions. The recovery has been slow—at a pace that won't restore employment to its 2007 peak until 2015.



start a recovery, but the gusher of government spending did have one clear result—greater deficits and debt. The federal government's red ink has exceeded 8.5 percent of GDP for three straight years. Debt has climbed above 100 percent of GDP, a dangerous level.

This isn't the economy Americans want.

Unleashing Capitalism

Interest groups and advocates have come to view the nation's economy as a public good to be plundered for the benefit of themselves and their constituents. Their efforts have brought us policies that reduce incentives to produce—by shifting the income-tax burden onto the most productive few, by giving the government control over a larger share of the national wealth, by breaking the link between production and consumption, by giving bureaucrats the power to overrule the collective wisdom of the marketplace.

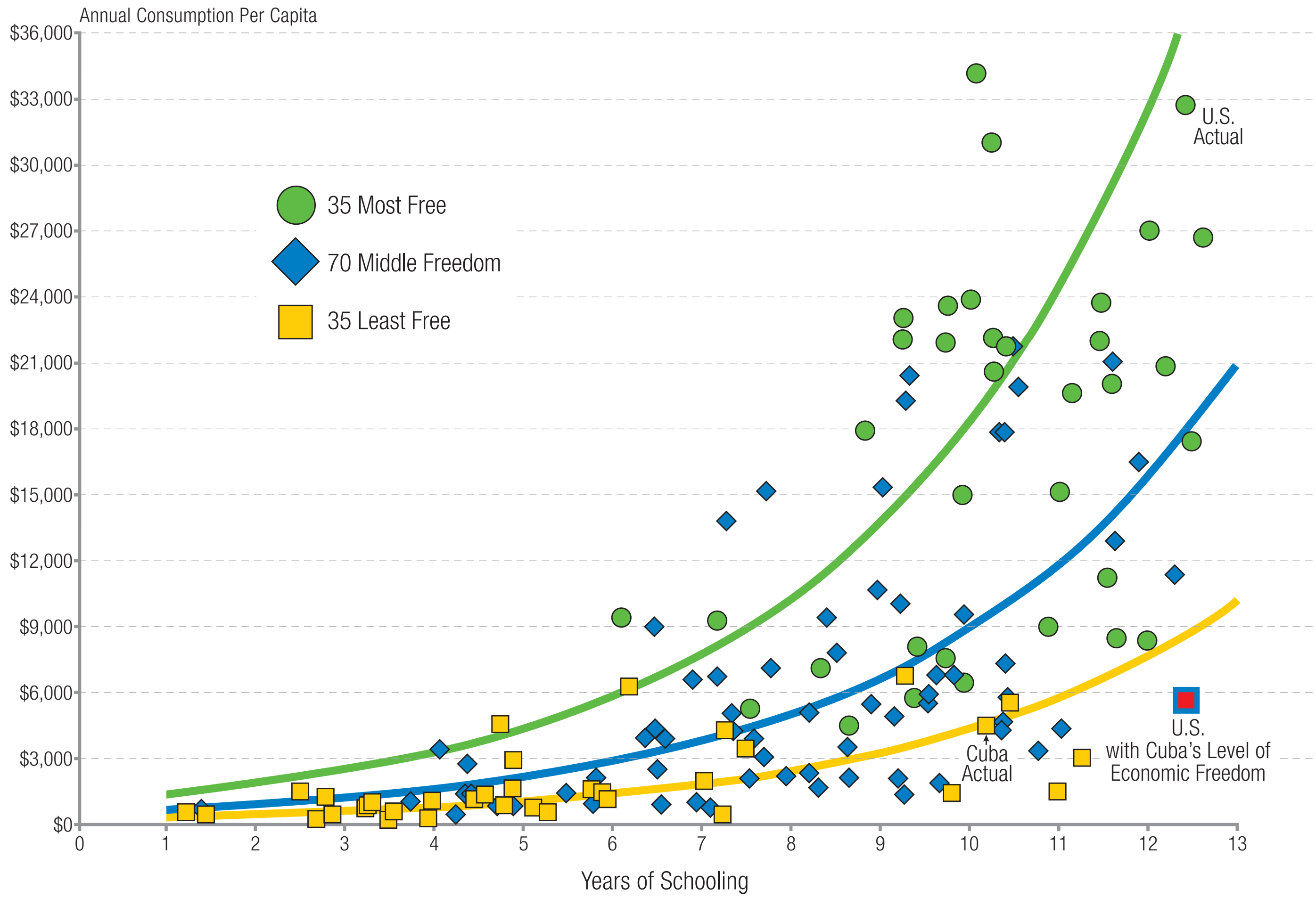
We're losing the economic freedom that for centuries has given American capitalism its vitality and drive. We would fight tooth and nail against any foreign invader who sought to take away our freedom. Yet, we have been willing to surrender it gradually—one compromise here and another one there, so most of us hardly notice what's going on. Until we wake up one day with an economy that's broken.

If he were alive today, Hayek would repeat his warning that we're on *The Road to Serfdom*. Down that road lies a descent into poverty. We can see it clearly by looking at education and economic freedom. The two measures explain roughly 70 percent of the variation in per capita consumption

EXHIBIT 11

It's the Economic System

Suppose we keep America's level of schooling the same at 12.45 years and reduce our *Economic Freedom of the World* score from its actual 7.96 to Cuba's 2.77. What happens to per capita consumption? It falls from $32,721 to $5,605—that's a rough estimate of the difference between capitalist and socialist systems. Averaging 10.2 years of education, Cuba is actually poorer at $4,440.



across countries. Additional years of schooling deliver a high payoff in the freest economies *(Exhibit 11, green line)*. Education doesn't buy much in countries where governments put the heaviest burdens on markets (*yellow line*).

Which matters most? Just take the average Americans' 12-plus years of schooling to Cuba and see how much it's worth. Here, it's $32,721 on average; there, just $5,605. Education matters, yes. But economic freedom matters more by ensuring a viable marketplace that values our knowledge.

Today as in the past, America possesses skilled workers, competitive companies, imaginative entrepreneurs—all the assets needed for a thriving economy. They will flourish in an economic and political system that respects incentives to work, save, invest, innovate, start businesses and take risks. They will wither in a system burdened by big government. Which way, America? Our choice is clear. By unleashing capitalism, we can restore the economic dynamism that creates jobs and raises living standards. By continuing down the road to serfdom, we will abandon economic freedom and condemn future generations to decline, dependence and decay.

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Richard Alm is writer in residence at the center (ralm@cox.smu.edu).

Notes and Data Sources

Exhibit 1:
Economic Freedom Pays Off
Source: Gwartney, James, Robert Lawson, and *Joshua Hall. Economic Freedom of the World: 2011 Annual Report*. Vancouver: Fraser Institute, 2011. The quartiles are based on the 1990-2009 average level of economic freedom, and the income numbers are 2009 data in U.S. dollars.

Exhibit 2:
'Led By an Invisible Hand'
Panel 1 Source: Current Population Survey, a joint effort between the Bureau of Labor Statistics and the Census Bureau. Available at: http://www.census.gov/hhes/www/cpstables/032010/perinc/new03_000.htm .
Panel 2 Source: "Best Undergrad College Degrees by Salary." *2010-11 College Salary Report*. Payscale.com. Available at: http://www.payscale.com/2010-best-colleges/degrees.asp.
Panel 3 Source: "Salary Increase by Major." *WSJ.com*. Available at: http://online.wsj.com/public/resources/documents/info-Degrees_that_Pay_you_Back-sort.html.

Exhibit 3:
Rewards for Taking Risks
Source: "Table 5-2: Indices of Year-End Cumulative Wealth, Year-End 1925 = $1.00. Inflation adjusted series. 1925-2010."*Morningstar Direct* [Online]. Values are in log base 10.

Exhibit 4:
Entrepreneurs Drive Growth
Source: U.S. Department of Commerce, Bureau of Labor Statistics. Available at: *Bls.gov*.

Box 2:
History's Greatest Anti-Poverty Program
1. What Poor Households Own
Sources: 1. "Residential Energy Consumption Survey." U.S. Energy Information Administration. Available at: http://www.eia.doe.gov/emeu/recs/.
2. "American Housing Survey for the United States: 2009." U.S. Census Bureau. Available at: http://www.census.gov/prod/2011pubs/h150-09.pdf .
3. Rector, Robert, and Rachel Sheffield. "Understanding Poverty in the United States: Surprising Facts about America's Poor." The Heritage Foundation, 13 Sept. 2011. Available at: http://www.heritage.org/research/reports/2011/09/understanding-poverty-in-the-united-states-surprising-facts-about-americas-poor.
2. Making Goods and Services Affordable
Source: Cox, W. Michael, and Richard Alm. *Time Well Spent: The Declining Real Cost of Living in America*. Dallas: Federal Reserve Bank, 1997. Annual Report.
3. Spread of Products Into U.S. Households
Sources: 1. Cox, W. Michael, and Richard Alm. *Time Well Spent: The Declining Real Cost of Living in America*. Dallas: Federal Reserve Bank, 1997. Annual Report.
2. "Residential Energy Consumption Survey." U.S. Energy Information Administration. Available at: http://www.eia.doe.gov/emeu/recs/.
3. "American Housing Survey for the United States: 2009." U.S. Census Bureau. Available at: http://www.census.gov/prod/2011pubs/h150-09.pdf .
4. Spread of Products Into Chinese Households
Source: Euromonitor International (2011). *Household Ownership of Durable Goods by Type of Household*. Retrieved from Euromonitor Passport Global Market Information database.

Exhibit 5:
Income Taxes: The Rich Pay More
Source: Logan, David S. "Fiscal Facts: Summary of Latest Federal Individual Income Tax Data." The Tax Foundation, 24 Oct. 2011. Available at: http://www.taxfoundation.org/news/show/250.html#table6.

Exhibit 6:
Penalizing Success in Business
Source: "Corporate Tax Rates Table: 2005-2012." KPMG. Available at: http://www.kpmg.com/global/en/whatwedo/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx.

Exhibit 7:
Tilting toward Redistribution
Source: "Table 3.1– Outlays by Superfunction and Function: 1940-2016." The White House. Available at: http://www.whitehouse.gov.

Exhibit 8:
Unstimulating Stimulus
Sources: 1. U.S. Department of Labor, Bureau of Labor Statistics.
2. Romer, Christina, and Jared Bernstein. *The Job Impact of the American Recovery and Reinvestment Plan*. January, 2009.

Box 3:
More Government, More Unemployment
Sources: 1. "Historical Statistics of the United States Millennial Edition Online." Cambridge. Available at: http://hsus.cambridge.org/HSUSWeb/HSUSEntryServlet.
2. U.S. Department of Labor, Bureau of Labor Statistics.
3. Chantrill, Christopher. "U.S. Government Spending Charts." *Government Spending Chart: United States 1903-2015*. Available at: www.usgovernmentspending.com.

Exhibit 9:
Heading the Wrong Way
Source: Gwartney, James, Robert Lawson, and Joshua Hall. *Economic Freedom of the World: 1970-2011 Annual Reports*. Vancouver: Fraser Institute. Lawson calculated a provisional U.S. score for 2010.

Exhibit 10:
An Economy Adrift
Source: U.S. Department of Labor, Bureau of Labor Statistics.

Exhibit 11:
It's the Economic System
Sources: 1. Economic freedom data is from Gwartney, James, Robert Lawson, and Joshua Hall. *Economic Freedom of the World: 1970-2011 Annual Reports*. Vancouver: Fraser Institute.
2. Schooling data is from "Educational Attainment in the World, 1950-2010." Barro-Lee Educational Attainment Data Set. Available at: http://www.barrolee.com/.
3. Per capita consumption data is from the World Bank, World Development Indicators. Available at: http://data.worldbank.org/data-catalog/world-development-indicators.

Exhibit 11 Methodology: To what degree does variation in schooling (S) and economic freedom (F) across countries explain variation in per capita consumption (C)? Cross section ordinary least squares regression analysis (in log base 2) yields the result:

$$C = \$39.28 \bullet 2^{0.415S} \bullet 2^{0.523F},$$

with t values of 10.5, 12.1 and 6.1 on the respective estimated coefficients of $39.28, 0.415 and 0.523 and an adjusted R^2 of 0.70. The regression suggests that variations in schooling and economic freedom explain 70 percent of the variation in per capita consumption across countries. As a counterfactual experiment, we keep the U.S. level of schooling at 12.445 years, third highest in the world. If we then lower U.S. economic freedom score from its actual level of 7.96 (6th highest at the time) to Cuba's score of 2.77, U.S. per capita consumption would fall from $32,721 to $5,605 a year. The implication is that roughly five-sixths of Americans' economic well-being stems from the thriving marketplace into which workers can sell their education.

A Conversation with Robert Lawson

Measuring Economic Freedom Around the World

Bob Lawson is co-author with Florida State's James Gwartney and Beloit's Joshua Hall of the influential *Economic Freedom of the World* report. The annual study, produced since 1996, ranks more than 140 countries around the world based on policies related to free markets and limited government.

Lawson joined the O'Neil Center in August. He's a graduate of Ohio University, who earned his PhD. in economics at Florida State University. He has taught at Capital University in Columbus, Ohio, and Auburn University in Alabama.

Lawson's scholarly articles have appeared in *Public Choice*, *Cato Journal*, *Kyklos*, *Journal of Labor Research*, *Journal of Institutional* and *Theoretical Economics and European Journal of Political Economy*. He's a member of the free-market Mont Pelerin Society and a former president of the Association of Private Enterprise Education.

Q: What is the *Economic Freedom of the World* report?

A: It tries to measure how closely a country's policies and institutions conform to the ideal of a free-market economy. My co-authors and I collect data from a multitude of sources on everything from taxes to inflation to tariff rates to minimum wages. In all, we use 42 different measures. To score well, a country must have reasonably low taxes, secure private property, sound money and stable prices, free trade and few regulations.

Q: Which countries rate the highest?

A: Hong Kong and Singapore consistently score first and second. The United States had for a long time been among the top five, but it fell to 10th in the most recent report *(see list)*. Runaway entitlement and stimulus spending certainly have played a role in this, but the various ratings on property rights have fallen dramatically, too.

Q: Why do we want to measure economic freedom?

A: We can learn a lot about the true meaning of freedom simply by trying to measure it. More important, a sound measure of economic freedom allows us to examine differences in economic and social outcomes as they relate to economic freedom. We now can show that people living in countries in the index's top quarter have incomes seven times larger and live 20 years longer than people living in countries in the bottom quarter. Economic freedom, as measured by our index, correlates in a positive way with virtually every indicator of economic and social well–being.

The 10 freest economies ... and the 10 least free

1. Hong Kong	132. Chad
2. Singapore	133. Burundi
3. New Zealand	134. Congo (Republic)
4. Switzerland	135. Guinea-Bissau
5. Australia	136. Central African Republic
6. Canada	137. Congo (Dem. Republic)
7. Chile	138. Angola
8. United Kingdom	139. Venezuela
9. Mauritius	140. Myanmar
10. United States	141. Zimbabwe

Q: You've calculated economic freedom indexes back to 1970. What are the grand themes of the index over the past four decades?

A: First, we see the effects of the Reagan and Thatcher revolutions all around the world. Starting around 1980, dozens of countries began privatizing state-owned enterprises, lowering marginal tax rates, reducing trade barriers and even eliminating military conscription. Between 1980 and 2007, the average score in the world increased. Second, the index can document the incredible gains to human freedom from the breakup of the Soviet Union. Former Soviet republics like Estonia and Georgia have made amazing moves toward economic freedom and now score in the top quarter of the world. Third, and perhaps most important, we can't take economic freedom for granted in the United States or elsewhere. The global average, like the U.S. score, has been declining in this decade, suggesting a worrisome retreat for economic freedom. There's growing cause for concern.

To read the latest *Economic Freedom of the World* report, go to www.freetheworld.com.

2011: Year in Review

The William J. O'Neil Center for Global Markets and Freedom added an internationally recognized voice on free markets in 2011— Robert Lawson, co-author of an annual study of economic freedom in more than 140 countries.

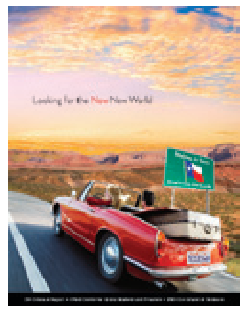
Lawson filled the newly created Jerome M. Fullinwider Endowed Centennial Chair in Economic Freedom. A donation from Sarah and Ross Perot Jr. of Dallas established the chair, named in honor of Mrs. Perot's father. At SMU, Lawson will continue his work on the *Economic Freedom of the World* report. For a decade, Lawson has been involved in the project, which unites researchers from around the world in compiling an extensive database to measure economic freedom *(for more on Lawson and the report, see interview on page 19)*.

Lawson joined six other faculty members in an expanded O'Neil Center—Director W. Michael Cox, SMU Cox Dean Albert W. Neimi, Dwight R. Lee, Maria Minniti, Michael Davis and Richard Alm. Kathryn Shelton, daughter of a free-market economist and a Wake Forest graduate, came to the O'Neil Center in August as its first research associate.

In March, The O'Neil Center's first spring event featured a speech by Fox News commentator John Stossel, broadcast journalism's foremost free-market advocate.

Speaking to an audience of 250 O'Neil Center guests and students at SMU Cox's Collins Center, Stossel described his journey from an anti-business crusader to a skeptic of Big Government policies.

After years calling down the government's wrath on wayward businesses, Stossel came to appreciate how markets deliver the consumer protection that regulators more often than not bungled. "The more I watched competition work, the more I saw that—Holy mackerel!—it solves problems better than government does," he said.



At the Stossel event, the center released its second annual report, highlighted by the essay "Looking for the 'New' New World," written by Cox and Alm. The essay examined migration within the United States—people voting with their feet—and determined why Americans have been moving to places like Texas and leaving places like California and New York.

The essay identified six significant drivers of net migration among the states—marginal income tax rates, the power of unions, the rate of increases in state spending, housing prices, the quality of schools and climate. Niemi contributed a message introducing the essay, and the annual report included an interview with Lee on capitalism's moral imperative.

The O'Neil Center ordered an initial printing of 18,000 copies of the 2010 annual report. A large portion of them were distributed to DFW executives, political leaders and SMU students. The report was sent to governors and legislative leaders in all 50 states—and every legislator in Texas. An additional mailing went to CEOs at major U.S. companies.

"Looking for the 'New' New World" received favorable coverage in *The Dallas Morning News* and other publications. Considerable interest came from media in California, a state reeling from the burdens of Big Government. The reports have made Cox an in-demand speaker. In May, for example, he presented the annual report to the North Texas Commission, an alliance of local Dallas-Fort Worth area local governments.

Executives of Andrews Distributing, a Dallas-based beverage company, funded creation of the O'Neil Center Speakers Series, set for launch in 2012. It will invite leading scholars to the SMU campus, where they will engage students, faculty members, business leaders and the general public on how markets work, the power of economic freedom and the role of government in a free society.

Free-Market Solutions

In October, the O'Neil Center hosted its third annual conference under the banner of "Free Market Solutions for Today's Toughest Problems." Almost 300 business leaders and students gathered at Collins Center to look at alternatives to Big Government in addressing such issues as energy, poverty, health care, education, retirement savings and global warming.

Cox took dead aim at the proposition that Big Government helps the poor, arguing that capitalism does more than social programs to raise living standards for low-income families. His presentation has been adapted for the box in this annual report's essay *(see History's Greatest Anti-Poverty Program, page 8)*.

Here are highlights from the presentation by other conference speakers:

Warren Stephens, CEO of Stephens Inc., the Little Rock, Ark., investment firm: Delivering the luncheon keynote address, Stephens took a hard look at the burdens and unintended consequences of financial market regulations since 2001. "All of these things were sold as regulations or changes to help the individual investor," Stephens said.

It didn't work out that way. For example, changing stock quotes from eighths to cents did reduce spreads between buying and selling prices—but at the cost of sharply increased stock market volatility. The number of daily swings exceeding 2 percent nearly doubled in the first eight years under the new pricing system. Decimalization encouraged computerized trading and reduced funding for research, Stephens said.

The high cost of compliance with the Sarbanes-Oxley law, passed in 2002, has led to a sharp drop in initial public offerings below $100 million. "The hassle of being a public company has been racheted up," Stephens said. To avoid Sarbanes-Oxley burdens, more companies are turning to private equity or choosing to list on foreign exchanges.

Stephens cited several other examples of new regulations that discouraged brokerage research, burdened investment banking and pushed investors into risky hedge funds. None of this has been good for the country. The past decade's regulation has harmed financial markets to the detriment of economic growth and job creation.

Lisa Snell, director of education and child welfare at the Reason Foundation: A tripling of public school spending over the past 40 years hasn't improved test scores, graduation rates or other measures of educational quality. Government-operated schools are failing a large number of American students, leaving parents and educators groping for a better way.

In more and more places, Snell argues, they're finding it in programs that introduce market-like competition that creates incentives to hire better teachers, innovate in the classroom and sweep away stifling bureaucracy.

Snell said school choice has reached a tipping point. Charter schools are the leading example of privatized education, with 6,000 schools and 2.5 million students in 2010. Los Angeles has opened 180 charter schools—and the public school system lost 200,000 students in five years. The District of Columbia issues vouchers to 1,700 at-risk students. Milwaukee's program covers nearly 25,000 students. Indiana has become the first state to make vouchers available to all students. After Hurricane Katrina, New Orleans didn't reopen its public schools and went to a system of 100 percent charter schools.

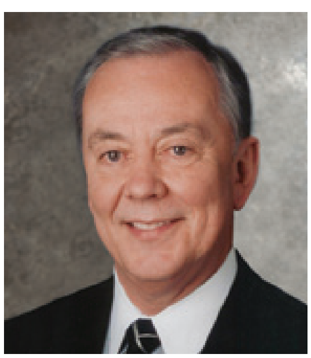
Just about all empirical studies show that greater school choice improves learning, even at traditional public schools that compete with charter institutions. Snell said market solutions have been winning because they provide better education at as little as half the cost of public schools.

B**rian Habacivch, senior vice president for research and publication for energy consultant Fellon McCord:** From 2001 to 2006, U.S. natural gas production had declined and prices were rising, reflecting a growing scarcity. Companies figured the Middle East would become the big supplier of U.S. needs, and they quadrupled the capacity of liquefied natural gas terminals.

Since then, the ingenuity of the private sector created a new reality—natural gas in abundance. The industry developed techniques to fracture underground rock formations and release trapped natural gas. In just three years, natural gas production soared to record levels.

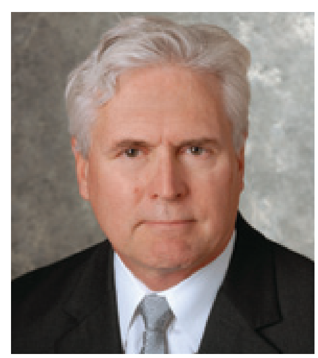
Energy prices collapsed to 10-

W. Michael Cox, Director, William J. O'Neil Center for Global Markets and Freedom



Albert W. Niemi Jr., Dean, SMU Cox School of Business

Dwight R. Lee, William J. O'Neil Endowed Chair in Global Markets and Freedom



Michael Davis, Professor, SMU Cox School of Business

Warren Stephens

year lows, taking down the cost of electricity and giving the United States a significant competitive advance in power. Manufacturing has benefitted. So has the petrochemical industry. The shale technology is being adapted to oil, and U.S. production is rising. "It's the next big thing," he said, noting North Dakota's output may soon equal Libya's.

Habacivch drew a lesson in free market economics. "The shale revolution didn't happen because of a blue-ribbon committee that got together in Washington," he said. "What happened was prices got very high and producers made it their business to find a lot of the stuff. Old-fashioned chasing profits completely changed the energy narrative from scarcity to abundance."

Habacivch described America as an energy giant. In production, the United States ranks first in natural gas, second in coal and third in oil. In reserves, the country is first in coal, second and rising in natural gas and fourth in oil. "When you add up the BTU value of our coal, oil and natural gas, we are the most energy rich nation in the world—by far," he said.

Robert Stavins, director of the Harvard Environmental Economics Program: Climate change vexes us because it's fundamentally a global commons problem. Countries that take unilateral action to reduce carbon emissions incur all of the costs but receive only a small part of the benefits. As a result, they have incentives to become free riders, leaving it up to other countries to take the action.

"Climate change requires international cooperation," Stavins concluded.

Command and control regulation imposes high costs on the economy, so Stavins recommends policies that work through the market rather than against it, providing incentives and flexibility to firms. "The result is we get the least costly solution to the problem," Stavins said.

To combat climate change, the economic consensus has settled on limits for carbon emissions coupled with tradable permits. "Cap and trade from the perspective of private industry is vastly less expensive than a carbon tax," Stavins said.

The price system encourages industries with low abatement costs to make larger contributions to reducing carbon emissions and provides incentives for innovations that save money. The market makes costs transparent—a positive from an economic perspective but an anathema in the political arena. Government typically tries to disguise costs and who pays them.

Cap and trade mechanisms were used to phase out leaded gasoline in the Reagan administration and to combat acid rain in the first Bush administration. Stavins worried that opposition to cap and trade would lead to command and control responses to climate change that would impose vastly higher costs.

Michael Tanner, senior fellow and director of the Social Security Choice project at the Cato Institute: The ghost of swindler Charles Ponzi often haunts discussions of the U.S. Social Security system, which taxes the present generation of workers to pay retirees' benefits. "There is one crucial difference between a Ponzi scheme and Social Security—Ponzi didn't have a gun," Tanner said. "No matter how bad a deal Social Security becomes, they can still force people to pay into it."

Social Security makes no actual investments, and it has run into trouble as the ratio of workers to retirees has fallen from 16 in 1950 to 3.4 today—on its way to 2.1 by 2030. Maintaining the Ponzi scheme that is Social Security comes down to a stark choice—reduce benefits or raise taxes.

Tanner recommended changing Social Security to a funded system—where workers' own contributions are invested to pay for their retirement benefits. Letting government make the investment decisions may lead to the poor returns or the bailouts and subsidies of politically driven slush funds.

"A much better alternative is to get the thing out of the hands of government altogether and allow individuals to make those investment choices," Tanner said.

In 1981, Chile replaced its Ponzi-style pension system with personal accounts, managed by the private sector and invested in productive assets that build the economy. Retirement benefits depend on contributions and accumulated returns. Now, about 30 countries have some form of privatized retirement system.

John Goodman, president and CEO, National Center for Policy Analysis: Decade by decade, the U.S. health-care system has become increasingly regulated and the spending on it has skyrocketed. The trends will accelerate under the Patient Protection and Affordable Care Act of 2010—better known as Obamacare.

By curtailing individual choice, Obamacare creates a bizarre set of perverse incentives. For example, companies will find it in their interest to dump low-wage employees onto the public sector. When they're healthy, some people will pay the relatively small fine for not having insurance—then jump into the system when they're sick.

The new law will increase demand for health care by bringing in the formerly uninsured and providing new benefits to the already insured—but it does nothing to increase the supply of doctors, nurses, hospital facilities and other medical inputs.

"We're going to have a big rationing problem," Goodman said. "The waiting is going to grow in the doctors' offices, emergency rooms and everywhere else care is sought. In that kind of market, you don't want to be in a plan that pays less than what all the other plans pay."

According to Goodman, America will get better health care at lower cost if individuals control the money and make decisions about care. Obamacare takes health care in the opposite direction, giving power to impersonal bureaucrats.

Videos, Publications, Speeches

The O'Neil Center continued to build its reputation as a nationally known voice for free-market economics. The strategy centered on spreading the word through videos, publications and speeches.

Cox worked with the Fund for American Studies on a short YouTube offering titled "Would You Give Up the Internet for $1 Million?" Turns out, nobody would—not even for $5 million or $10 million. In the video, Cox pointed to the Internet's high value relative to cost, attributing it to capitalism's capacity to deliver higher living standards by making products better and cheaper.

Working with SMU Cox marketing staff, the center produced a four-minute video with a response to a question many are still asking: What is the O'Neil Center? Cox and Niemi explained the center's origins and mission. Lawson gave a pitch for the *Economic Freedom of the World* report.

The growing ties between the O'Neil Center and Bush Institute were once again evident when the former president's think tank invited Cox and Minniti to join other nationally known economists—including several Nobel Prize-winners—at an April conference on boosting economic growth. Cox and Alm contributed an essay on the

Robert Lawson, Jerome M. Fullinwider Chair in Economic Freedom

Maria Minniti, Professor and Bobby B. Lyle Chair in Entrepreneurship

Richard Alm, Writer in Residence, William J. O'Neil Center for Global Markets and Freedom

Kathryn Shelton, Research Associate, William J. O'Neil Center - for Global Markets and Freedom importance of incentives to *The 4% Solution*, a Bush Institute conference volume to be published in 2012. The book will also include Minniti's essay, based on her conference presentation titled "Female Entrepreneurship and Economic Growth."

Dallas' *D CEO* magazine published two Cox and Alm illustrated articles, one on how better schools affect migration within the Dallas-Fort Worth area and the other on the importance of globalization to DFW's top public companies.

Lawson and Alm wrote a December 2011 op-ed for the *Investor's Business Daily*, which chided the Occupy Wall Street movement for ignoring the enormous concentration of economic power in the U.S. Congress *(reprinted inside back cover)*.

Lee's 2011 publications included "The Economics of Caring and Sharing" in *The Freeman* and "Happiness, Adaptation and Decreasing Marginal Utility of Income" in the *Journal of Private Enterprise*. Lawson co-authored "Economic Freedom and Happiness" with J. Thorne, Jr., published in the *Cato Journal*.

Minniti edited a book titled *The Dynamics of Entrepreneurship: Evidence from the Global Entrepreneurship Monitor Data*. She also co-authored articles in professional journals—"Gender Differences in Entrepreneurial Propensity" in the *Oxford Bulletin of Economics and Statistics* and "Demographic Structure and Entrepreneurial Activity" in *Strategic Entrepreneurship Journal*.

The O'Neil Center began an Internet publication called *Economic Insights*. The first issue countered *New York Times* columnist Paul Krugman's attempt to use budget shortfalls to minimize Texas' economic success. Cox and Alm pointed to what really matters—Texas' leading role in job creation and its attractiveness to migrants from other states.

O'Neil Center faculty delivered dozens of speeches in 2011, addressing business groups, academic conferences and civic organizations. Cox spoke frequently on two topics—economic freedom and growth in Texas and emerging economic trends over the upcoming decade. Lawson gave lectures on the *Economic Freedom of the World* report in Turkey, Italy, the country of Georgia and several parts of the United States.

At April's Association for Private Enterprise Education (APEE) meeting in Nassau, the Bahamas, Lee presented a paper titled "Shrinking Leviathan: Can the Interaction Between Interests and Ideology Slice Both Ways?" Lee spoke about "Markets and Mortality" at the Southern Economics Association in November.

At the APEE meeting, Alm used the 2010 annual report's research for "Testing Tiebout: Interstate Migration and Economic Freedom." He delivered a second presentation on "Economic Freedom and Globalization on a Micro Level," highlighting the DFW area.

Media outlets continued to call upon O'Neil Center expertise. Cox was featured on *Nonstop Nightly* on NBC DFW about the prospect of Governor Rick Perry as a presidential candidate in August 2011. Cox became a regular on Fox Business's national coverage of the Federal Reserve, joining other commentators for an on-air discussion of the central bank's policy-making meetings and the subsequent Ben Bernanke press conferences.

Local television and newspapers called on Davis frequently to explain such events as the American Airlines bankruptcy. In September, the O'Neil Center was part of release of the *Economic Freedom of the World* report's 2011 edition, with Lawson discussing it on CNBC's Worldwide Exchange, CNN and other media outlets.

At the end of the academic year, both Cox and Davis were honored for being among the Cox School of Business' Top 10 in media interviews and citations.

Shelton was among the 40 young people selected for the Koch Institute's Liberty@Work program, a 10-month training program for employees of free-market organizations. Her participation has allowed her to network extensively with like-minded groups around the country, raising the O'Neil Center's profile.

To keep its supporters informed, the O'Neil Center assembled a database of those interested in its work and began to send out short e-mail alerts. A dozen alerts were sent out during in 2011. The e-mail list exceeds 450 addresses and newcomers can register at the O'Neil Center web site.

Teaching will always be a priority at the O'Neil Center. The faculty taught classes in basic economics, markets and freedom and finance. Neimi created a new class on the evolution of American capitalism, organized by major subject areas rather than chronologically. Cox took on teaching undergraduates about money and capital markets—with a strong emphasis on how finance fits in the overall fabric of a market economy. Cox continued to carry the lion's share of the load on the ongoing Women's Economics and Finance Series at SMU Cox.

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PERSPECTIVE

The 0.00017% Vs. 99.99983%: Time To Occupy The Capital?

ROBERT LAWSON AND RICHARD ALM

The consistent theme of the Occupy Wall Street movement has been outrage over the concentration of income in the hands of America's rich.

In cities all over the country, protesters are drawing the battle line between the top 1% and the rest of us in the bottom 99%. Too much economic power is in too few hands.

It's unfortunate indeed that the Occupiers have so far ignored the country's most egregious concentration of economic power.

In 2010, a tiny cabal of 535 individuals — just 0.00017% of the population — spent $3.5 trillion, or about 23% of the $14.5 trillion U.S. economy. That leaves 77% for the other 99.99983% of us.

The group is the U.S. Congress — whose members have enormous powers to tax and spend. And they've used them to grab economic power well beyond anything found in the private sector.

If we look at the richest 535 private citizens, measured by the Forbes 400 list combined with estimates for the nation's next 135 wealthiest people, we estimate these rich people probably have about $166 billion in spendable income each year.

Internal Revenue Service data from the 535 highest tax returns give a somewhat lower figure of $135 billion.

Thus, the members of Congress wield 20 to 25 times more economic power than the same number of richest private citizens in the country.

The lawmakers even put the richest 1% to shame. The Occupiers' bogeymen earn a combined $1.3 trillion a year in income, or less than 40% of what Congress spends each year.

Most private individuals become wealthy by providing valuable goods and services to consumers who have a choice of whether or not to buy. Bill Gates, for example, reached the top of the Forbes 400 by providing computer software to millions of people around the world.

If rich people invest in producing products no one wants, they lose money and find themselves replaced in the economic pecking order by people who made wiser choices.

In the past year alone, 18 new members climbed into the Forbes 400, nearly all of them self-made entrepreneurs.

In contrast, Congress takes its money from taxpayers by force and meets regularly to conspire on how to spend these immense sums of money.

Yet there is little guarantee that they will create value with their spending. If their politically motivated "investments" fail, as with Solyndra or the various "bridges to nowhere," taxpayers lose but politicians suffer no consequences. Members of Congress keep their jobs and move on to spend trillions more.

But it gets even worse. In addition to commanding vast sums of money, members of Congress also claim the power to regulate everything — our light bulbs, our showerheads, the price we pay for sugar, our health care choices, and on and on and on.

Rich people can't force anybody to stop buying 100-watt incandescent light bulbs but Congress sure can.

If concentrated income in the hands of a few elites is really a problem, we should direct our ire toward the U.S. Capitol, not Wall Street.

• Lawson holds the Jerome M. Fullinwider Chair in Economic Freedom. Alm is writer in residence in the O'Neil Center for Global Markets and Freedom in the SMU Cox School of Business.

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