Rebuilding America's Middle Class

Prosperity Requires Capitalism in the Classroom

2012 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

We're fortunate at the SMU Cox School of Business. Our students are better than ever, arriving on campus prepared to succeed in college and beyond. In 2012, the incoming freshman class of BBA Scholars had an average SAT score of 1,425 and a high school GPA of 3.55.

While we're doing well, I worry about the broader problems with U.S. education. Many of our high schools are failing to prepare students for college and for a job market that demands better educated workers. Without a smart, sophisticated labor force, our economy cannot stay on top in the face of the inexorable forces of rapid technological change and global competition.

These issues are the catalyst for "Rebuilding America's Middle Class," the O'Neil Center's fourth annual report essay. Michael Cox and Richard Alm examine the economic transformation roiling the middle class, explain why our public schools aren't performing as well as they should and argue that only more competition will improve education. It's a powerful message—one Americans need to hear.

At SMU Cox, we know competition breeds excellence. We make our students compete in the classroom, and they're better off for it. We compete with other leading universities for the best students. Facing this competition is a big reason we've risen to the top ranks of U.S. business schools.

Following the essay, the annual report introduces the O'Neil Center Advisory Board. Jerry Fullinwider, its chairman, has brought together a remarkable group of business leaders to help guide the O'Neil Center's research and programs. Fullinwider follows in the footsteps of Ed Cox, Cary Maguire, Carl Sewell, David Miller and so many others who've given their time and money to SMU Cox, making an investment in our students, our economy and our country. I cannot thank them enough.

Now, turn the page. Read "Rebuilding America's Middle Class." I know you'll find the essay a worthwhile investment of your time.

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

Rebuilding America's Middle Class

Prosperity Requires Capitalism in the Classroom

By W. Michael Cox and Richard Alm

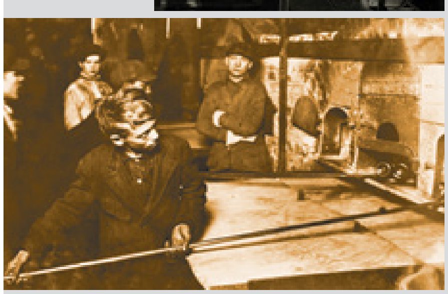
For generations, middle class was the destination of the American Dream. A few of us aspired to wealth and luxury, but most Americans sought little more than a place in the comfortable and respectable middle class. And why not? History had never before seen anything like the vast American middle class of the mid to late 20th Century—so many people living so well.

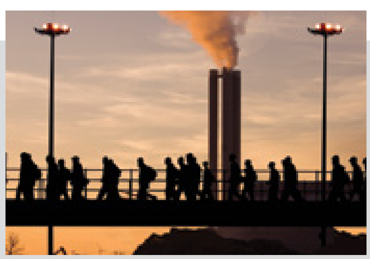
Today, many see this middle class in peril, and it's not hard to understand why. The typical American family has been put through the wringer in recent years—a long and deep recession, millions of lost jobs, shrinking retirement accounts, record foreclosures, falling home prices and an agonizingly slow recovery wrought by unsteady economic policies.

Middle class America emerged from the ordeal anxious and confused, searching for answers. Politicians and commentators seized on the angst, fanning the flames with jeremiads on the hollowed out middle class and the country's growing inequality—often pointing an accusing finger at capitalism itself.

For our economy, for our peace of mind, for our future, it's important to understand what's gone wrong—and how we can fix it.

America's first middle class grew out of the Industrial Age's factory work …





Most explanations for middle class decline are off target, but one hits the bull's eye—the mediocrity and inconsistency of America's public schools. In today's globalized, knowledge-intensive economy, reaching the middle class and staying there requires brains rather than brawn. Education marks the path to success, now more than ever, but our centralized, bureaucratic public school systems leave too many students unprepared for the jobs that now pay middle class wages.

Rebuilding America's middle class will require innovative, world-class schools that equip students for success in today's job market. Better schools are certainly within our means, but we won't get them with current assumptions and institutions. Decades of education policy and higher spending haven't improved the quality of American education.

It's time to harness the tried-and-true forces of capitalism—most important, choice and competition. Capitalism in the classroom will create proper incentives, spur innovation and drive entrepreneurial activity. The same system that forged the physical capital to build America's first middle class can mold the intellectual capital to construct a middle class for the knowledge-intensive economy.

Shifting Ground

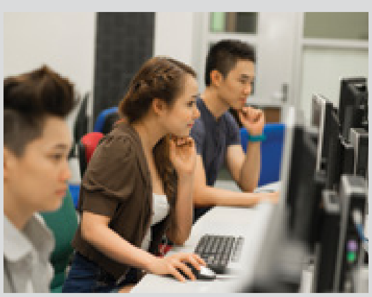
Middle class conjures images of families living in comfortable, safe and well-kept homes, with a full complement of household appliances, a car or two in the driveway, televisions, computers, other electronic gadgets, traveling and dining out on a regular basis. The middle class lifestyle came with the security of good jobs and the expectation that children will be even better off than their parents.

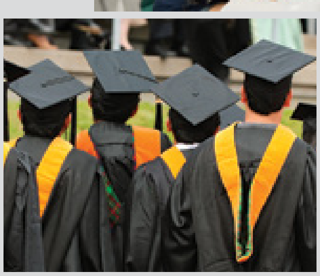
Most American families still enjoy the material trappings of middle class life, refuting any notion of an absolute fall in living standards for any broad segment of society. However, the past decade or so has been tough on the middle class. Adjusted for inflation, average wages and median household incomes have risen slowly and, at times, slid backward.

Even more glaring is the middle class' *relative* decline. Take a look at households above the bottom 20 percent of the income distribution and below the top 20 percent—the middle 60 percent, the broad swath of the middle class. In 1970, these households had 53 percent of the national income. Since then, their share has dwindled to 46 percent.

As the ominous data roll in, the

… but today most jobs paying middle class wages require knowledge, expertise and talent.





"Physical capital made workers more productive and pay rose, allowing millions more Americans to climb into the middle class."

country has been looking for the reasons behind the middle class' plight. Is it new technologies that pay off handsomely for the well-educated and entrepreneurial but displace and devalue ordinary workers? Or has it been the outsourcing of work to low-wage labor in China, India and other countries? Immigrants that come to America willing to work at low wages? Tax policies that benefit the rich at the expense of the middle class? Feeble productivity growth, especially in heavily unionized industries?

While some of these accounts contain kernels of truth, none stresses education at a time when knowledge's value is rising. America won't understand what's happening to the middle class without focusing on two underlying causes—the evolution of how we produce goods and services and the troubles in our public schools.

America's middle class grew out of the Industrial Age and its reliance on *physical capital*—the buildings, machinery and equipment that churned out everything from steel girders to safety pins. Profit-seeking capitalists provided it, outfitting the assembly lines and hiring displaced farmers migrating to the cities. For the most part, the work required physical strength and manual dexterity, both natural attributes of human beings. Employees learned most of what they needed on the job, not in their local school's classrooms.

In sprawling and belching factories, workers punched time clocks and toiled on assembly lines, earning roughly equal middle-income wages, based on rising average productivity (*Exhibit 1*). As the economy accumulated capital, workers became more productive and pay rose, allowing millions more Americans to climb into the middle class. Industry employment—manufacturing, mining and construction—reached a peak of more than 37 percent of private sector workers in the early 1950s.

Over the next five or six decades, trade and technology brought waves of Schumpeterian creative destruction, transforming the economy and changing the nature of industrial employment.

Trade expanded, intensifying competition and reordering production. American factories continued to turn out more goods—but they moved up to produce high-value ones such as aircraft and semiconductors and ceded the lower-value manufactures such as apparel and toys to countries abundant in cheap labor.

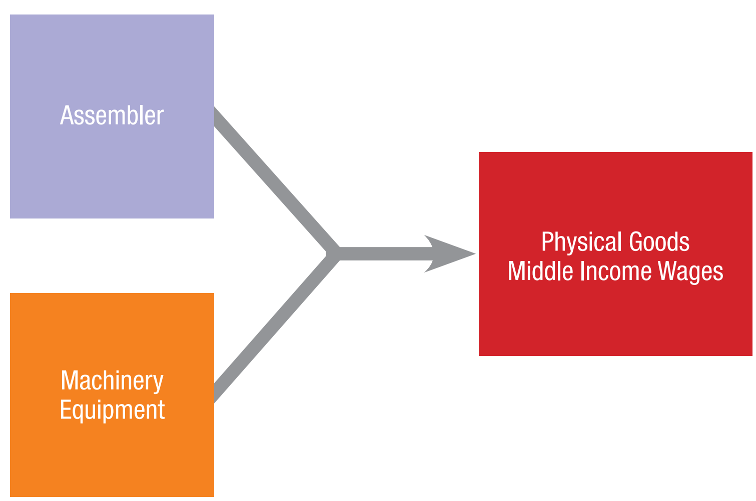
Technology led capitalists to develop ever-smarter machines that in many cases performed the routine assembly-line tasks more cheaply than workers did, with greater precision. Computer-controlled assembly lines could operate with a few educated and highly paid technicians, diminishing the need for many of the less educated workers who had been the backbone of the earlier industrial era.

Trade and technology gave consumers better and cheaper goods, but U.S. factory employment went into decline, slowly at first, then precipitously. Today, the once-

EXHIBIT 1

America's First Middle Class

A generation or two ago, the U.S. economy relied on capitalists to provide machinery and equipment to turn out physical goods, making industrial workers productive enough to command middle-income wages. Skills were learned on the job, not at school.



dominant industrial sector employs just 16 percent of the labor force. The Americans who remain in the factories are facing stagnant wages and job insecurity. With factory jobs harder to find and pay lagging, industry can no longer offer a reliable path to the middle class for the great bulk of American workers and their families.

"Intellectual capital resides within the workers themselves, so it doesn't end up replacing them."

Services Ascendant

Economic changes on the supply side coincided with an evolution of consumption on the demand side. As American households grew wealthier, they spent relatively less of their income gains on physical goods—after all, most of us had already moved well beyond the basics of food, clothing and shelter to acquire the paraphernalia associated with a middle class lifestyle. Increasingly, households' added income went to buying the services farther down their collective list of needs and wants—everything from lawn mowing to Caribbean cruises.

Progress typically unfolds in this way—growth in demand slows for goods, accelerates for services. The labor market makes a corresponding adjustment, moving workers from producing goods to providing services.

Expanding trade, new manufacturing technology, evolving demand—all of these grand themes worked against the Industrial Age middle class. The shifting ground left Americans to seek another way to achieve their middle class aspirations.

Many are finding it—this new path to the middle class. They get an education that prepares them for the good jobs being created in the booming services economy. Today's high-paying work relies less on physical strength and manual dexterity and more on knowledge, expertise and talent.

Physical capital doesn't drive the economy like it once did; it has lost ground to intellectual capital, the economists' short-hand for what workers know that makes them more productive.

Stark differences divide the two forms of capital. Physical capital belonged to the industrialists, who supplied it by investing in their enterprises. Workers and physical capital remained separate. If workers left, physical capital stayed behind; if the machinery and equipment could do the job better or cheaper, it replaced workers.

By contrast, workers build intellectual capital internally by investing time and effort in learning, usually by going to school. Intellectual capital can't belong to the company; it resides within the workers themselves, so it doesn't end up replacing them.

With services ascendant, intellectual capital has become increasingly valuable—the *de facto* dividing line between the "haves" and "have nots." In knowledge-intensive services, education and expertise make workers highly productive, paying wages high enough to get to the middle class and stay there (*Exhibit 2*). Among American males aged 25 to 34 with full-time jobs, workers with bachelor's degrees earned an average of $63,000

EXHIBIT 2

Now, It's What You Know

Services workers dominate the U.S. economy, making intellectual capital more important. Educated workers possess the skills to command wages high enough to achieve middle class status or better (*top*). Less educated workers provide services but struggle to make it into the middle class (*bottom*).

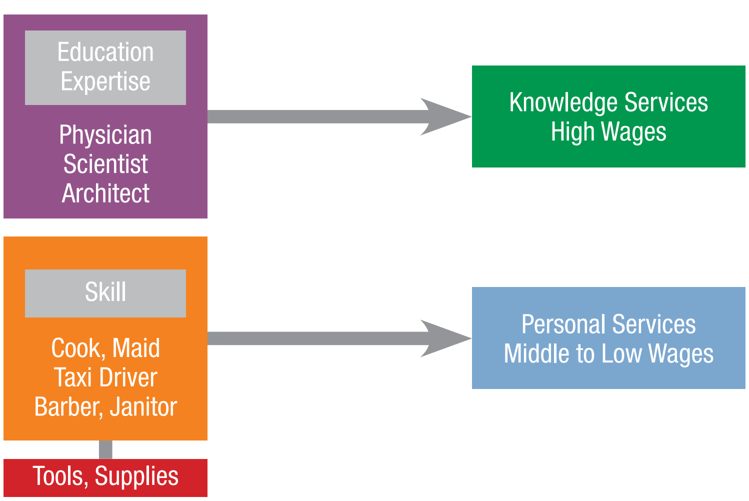


EXHIBIT 3

Surest Way to the Middle Class

Education leads to higher incomes. Getting a college degree allows American workers to earn an average of $63,000 a year—a middle class income. Advanced degrees raise incomes even higher. Meanwhile, high school dropouts and graduates struggle to make it into the ranks of the middle class. It shouldn't be that way.

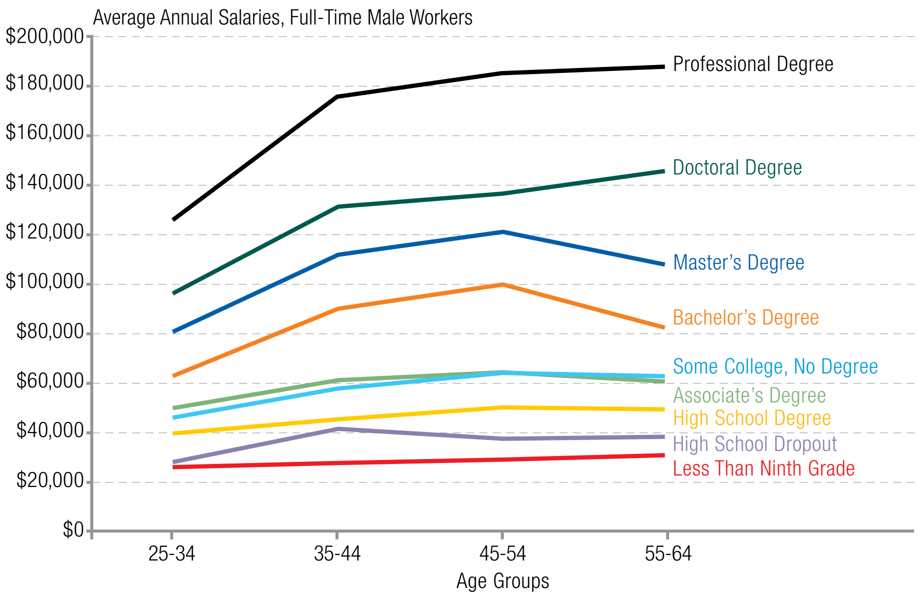
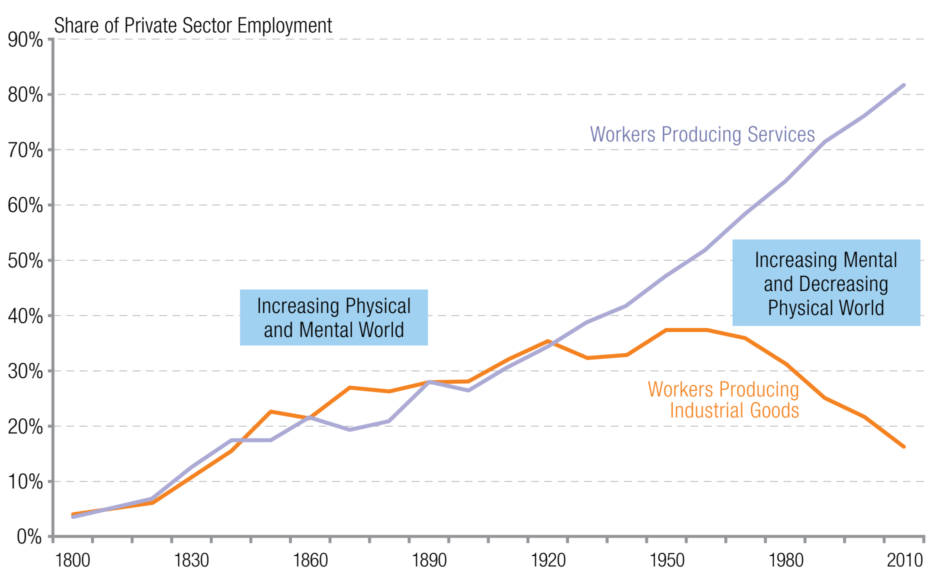


EXHIBIT 4

Less Brawn, More Brains

Until the 1920s, jobs producing industrial goods and services both increased their share of the labor force, with agriculture declining. After that, services jobs continued their rise, while industrial jobs grew more slowly. Factory employment began to shrink in the 1970s, making it harder for less educated workers to find their way into the middle class.



in 2010. Incomes rose to $97,000 with doctorates and $126,000 with professional degrees (*Exhibit 3*).

For workers with less education, factories no longer provide many well-paying jobs. Instead, many low-skilled workers find employment in personal services, which usually pay middle to low wages. Working full time, an average 25- to 34-year-old male who didn't finish high school earned roughly $27,000 a year—not enough to make it into the middle class. High school graduates did better at an average of $40,000, still not enough to pay for the lifestyle most Americans want.

Better educated workers see incomes increase as they hold jobs and gain experience—at least through their middle years. By contrast, years of work don't add much to the incomes of less educated workers. Unemployment rates show a similar dichotomy. They're lowest among the better educated. Workers with fewer years of schooling face the highest jobless rates. For the less educated, dead-end jobs and unemployment are additional barriers to achieving and maintaining middle class status.

Physical capital complements the physical work of goods production. Intellectual capital is vital to the mental work of providing many highly valued services. Taking a long view, the transition from physical to mental work has been striking. In the first century of industrialization, with the economy shrugging off its dependence on agriculture, both physical and mental work expanded as a share of the labor force (*Exhibit 4*). After that, physical work's share ceased to grow for decades before starting on a long decline after 1975. Mental work's share has kept growing—right up to the present.

America's middle class had its roots in the Industrial Age. It deteriorated during the transition to a knowledge-based economy because too many workers weren't prepared for the high-paying services jobs that form the foundation of today's middle class. The fault lies with our public schools.

Time Ill Spent

About 90 percent of U.S. children attend public schools, typically from ages 5 to 18—their all-important formative years. During that time, most students spend nearly a million minutes in the classroom. For too many of them, it isn't time well spent.

Compared to the rest of the world, U.S. schools aren't doing a good job of educating the workforce of the future. Among 15-year-old students in 34 Organization for Economic Cooperation and Development countries, tests measuring 2009 student performance rank Americans 25^{th} in reading, 17^{th} in math and 14^{th} in science (*Exhibit 5*).

This is no anomaly. U.S. students' scores lag among other age groups—and they have done so for decades, with few signs of improvement despite the grand promises of No Child Left Behind and the new mania for achievement tests designed to identify poorly performing schools and teachers.

Most students want to learn and succeed. Schools that don't teach well frustrate them. Many simply give up and drop out of school. The U.S. high school graduation rate is only 75 percent, well below the OECD average of 82 percent. At least 10 OECD countries manage to graduate 90 percent or more of their secondary school students.

EXHIBIT 5

Little to Brag About

A good education is the foundation of the middle class in a knowledge-based economy. However, U.S. students aren't performing well on international tests for math, reading and science—a sign that the nation's public schools aren't providing the highest quality education.

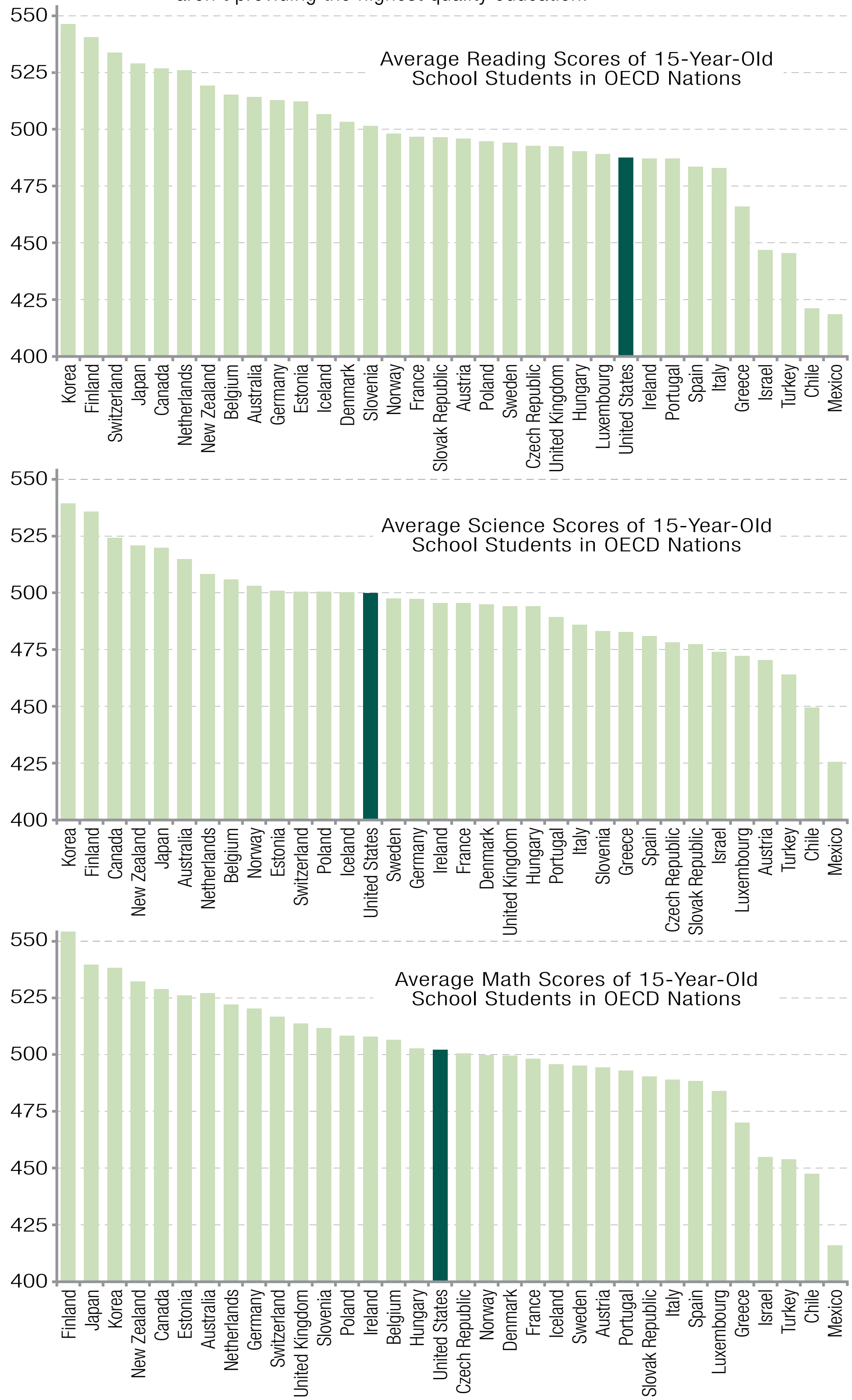
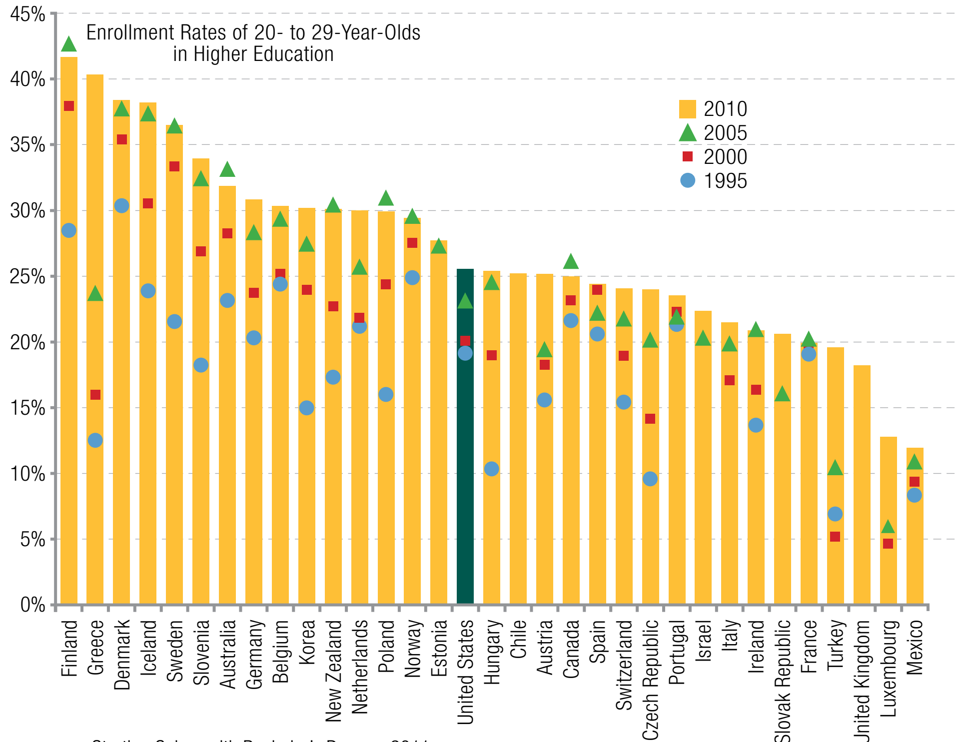
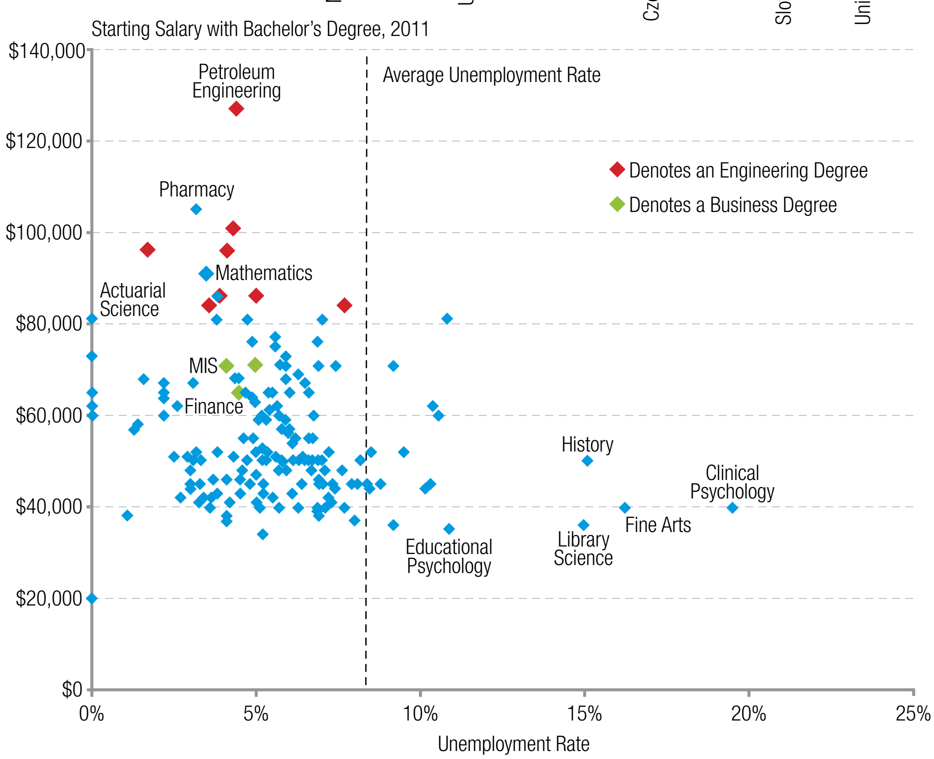


EXHIBIT 6

Not Ready for College

Public schools struggle to prepare students for the next level, affecting decisions about whether to go to college and what to study. Among OECD countries, the United States lags in college enrollment among 20- to 29-year-olds (*top*). Many students come out of high school ill prepared to succeed in majors that lead to jobs with high pay and low unemployment (*bottom*).





U.S. public schools' poor performance takes its greatest toll on America's minorities. Compared to whites, black and Hispanic students attend the worst schools, score lower on standardized tests and drop out at higher rates. It's no coincidence that these minorities also have a more tenuous grip on the middle class.

The sad legacy of America's public schools doesn't end with lower pay and higher unemployment among the least educated young people. A second-rate high school education bars many young Americans from attending college. Among OECD countries, the United States ranks just 16th in the share of those aged 20 to 29 in higher education (*Exhibit 6, top*). It isn't because the United States doesn't have enough room on its college campuses.

Even those who do go on to college bear a burden. Thirteen years in U.S. public schools leave many students ill prepared for the rigors of a college curriculum. Too often, limited academic skills rule out such majors as engineering, the sciences, statistics, economics and finance—all of which lead to higher paying careers (*Exhibit 6, bottom*). At U.S. colleges, 36 percent of foreign students earn bachelor's degrees in the STEM disciplines—science, technology, engineering and math. For U.S. students, it's just 12 percent.

Math-phobic American students opt to major in English, social work and other fields where college graduates earn less and face high unemployment. While many college graduates struggle to find good jobs, companies that can't find enough U.S.-born engineers and scientists hire foreigners, doing it overseas if necessary.

America does have some good

public schools, capable of preparing students for college and good jobs, no doubt. Unfortunately, too many schools are mediocre or even downright dismal, failing our children and undermining the middle class.

Money Illusion

Americans know all to well the failings of our educational system, so fixing public schools has become a national obsession. Politicians at every level campaign on fervent pledges to make the U.S. schools the best in the world. Reform proposals flow in torrents from reports, commissions, working groups and research projects.

One thread winds through much of the advocacy: spend more money. But that's what we've been doing for two or more generations—from local school districts right on up to the Department of Education. As a result, the United States already spends more per student than any other country.

Andrew J. Coulson, director of the Cato Institute's Center for Educational Freedom, calculates that U.S. spending per pupil more than doubled from $5,500 a year in 1970 to more than $13,000 in 2010 *(Exhibit 7, left)*. What did the nation get for its money? Nothing—at least when measured in terms of educational quality. Since 1970, average test scores among 17-year-olds were flat in reading and math and down in science.

Bigger budgets don't translate into better educational outcomes in part because of how school systems spend money. The real beneficiaries of increased spending have been educational bureaucrats, not students. According to the U.S. Department of Education, public school enrollment increased 96 percent from 1950 to 2009—but the employee head count rose 386 percent. Teachers make up only a fraction of the expanding employment because administrators and other staff expanded at a phenomenal 702 percent *(Exhibit 7, right)*.

Yet the money illusion persists, largely because of the apparent link between spending and school quality at the state level. Outlays per student range from $6,356 a year in Utah to $18,126 in New York—a gap of $11,770. Run a simple regression with state spending and average eighth-grade scores in math, reading and science, and it shows test results rise with education budgets—case closed, or so advocates of more education spending would have us believe.

The big spenders, however, are relying on raw data with a fatal flaw—states vary widely in cost of living, incomes and demographics, affecting the relationship between educational spending and student performance.

It costs a lot more to live in New York than in Utah, so part of the school spending differential merely reflects what employers routinely pay to compensate for New York's expensive housing and high taxes. In the state data, the cost of living impacts the real value of educational spending.

States with high living costs also tend to have high average incomes, which are in turn correlated with the adult population's average years of schooling. In measuring student performance, we can't ignore the impact of parents' education.

Demographic differences among states become important because

EXHIBIT 7

Education's Bottom Line

America hasn't been short-changing its public schools. After adjusting for inflation, spending per pupil has climbed sharply over five decades. The added resources haven't paid off in higher student test scores (*left*). Bigger budgets have funded huge jumps in employment that far outstrip enrollment increases (*right*).

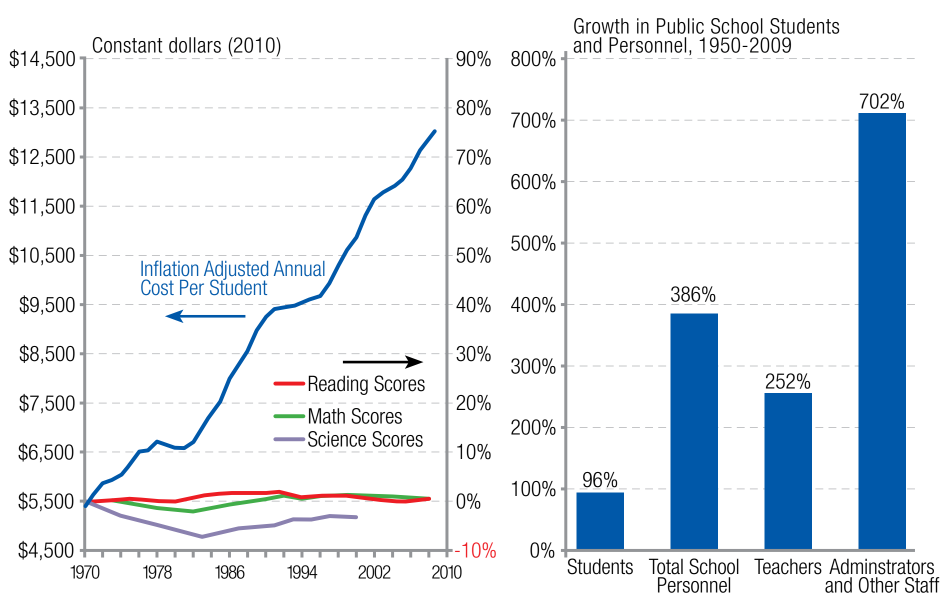
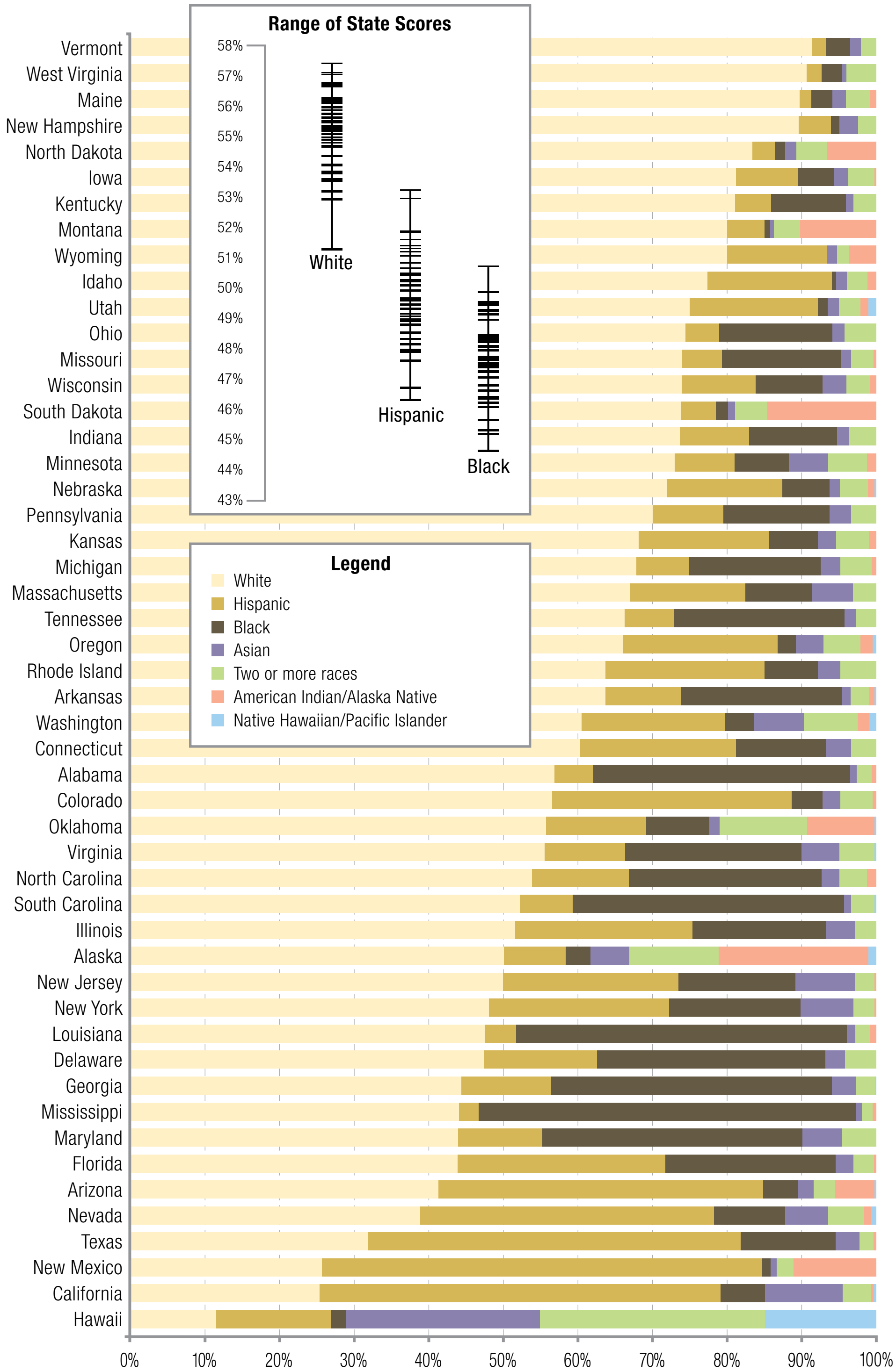


EXHIBIT 8

Demographic Dilemma

On eighth-grade tests in math, reading and science, white students do better than Hispanics and blacks (*inset*). States vary dramatically in ethnic composition (*right*)—and average tests scores will capture differences in both demographics and educational quality.



white students score higher than Hispanics and blacks on standardized tests *(Exhibit 8)*. States with large minority populations will see their average scores and rankings reduced, making their school systems appear worse. States with larger white populations will record higher average test scores, even if they're not spending their educational money any more effectively.

It's important to take these state-level differences into account. A cost of living adjustment puts all states on an equal footing and reorders the ranking, replacing New York with Wyoming as the top spender and reducing the gap between the highest and lowest spenders from $11,770 to $7,813 (*Exhibit 9*).

Eliminating demographic bias involves adjusting each state's data to reflect the national mix of major ethnic groups in public schools: 59.2 percent whites, 24.6 percent Hispanics and 16.2 percent blacks. Looking at eighth graders' average scores across math, reading and science, schools in some states rise in the pecking order—Texas from 28th to 3rd; Maryland from 27th to 5th; Alaska from 34th to 12th; Delaware from 29th to 11th. Schools in other states fall in the rankings once they lose their edge—Vermont from 2nd to 18th; Maine from 11th to 34th; Iowa from 23rd to 40th (*Exhibit 10 on Page 12*).

With more accurate spending and demographic measures, education budgets' power to lift student achievement disappears—it's no longer statistically significant in a regression (*see Methodology, Page 17*).

So why do some states have better public schools—if it's not a matter of more money? A regression using three data series—COLA-adjusted spending, per capita income and share of the population over age 25 with a college degree—finds that demographically corrected test scores improve significantly with higher incomes and more college-educated parents.

The intuitive story goes like this—educated parents make more money, and they appreciate the value of schooling. They insist on better schools for their children and stress education at home. School districts that spend more tend to have a high cost of living, high average incomes and better-educated adults. But that *doesn't* mean more money makes schools better.

Rebuilding the middle class requires harnessing the demand for better schools and using it to produce an educated workforce. The impediment is a government-run school system resistant to innovation, indifferent to student needs and mired in mediocrity. We won't improve our schools until we get government out of the way.

Choice and Competition

In education as elsewhere, the alternative to government is the private sector, already the foundation for the good life of the American middle class. Market competition has a long history of driving innovation, raising quality and lowering costs.

Take the cell phone. It hit the U.S. market three decades ago as a two-pound brick studded with big buttons, and it just made phone calls—at least some of the time. In 1984, a typical Motorola cell phone cost $4,195, a sum it took an average worker 464 hours to earn. Needless to say, early cell phones were beyond the means of the middle class.

Over the next three decades, cell phones morphed into smart phones, weighing just a few ounces and fitting neatly into pockets or purses. They

EXHIBIT 9

Getting Spending Right

What states spend per student reflects differences in salaries and other expenses—a fact not recognized in the usual ranking (*left*). A cost of living adjustment clarifies the actual differences in education spending, reducing the gap between the high and low spending states (*right*).

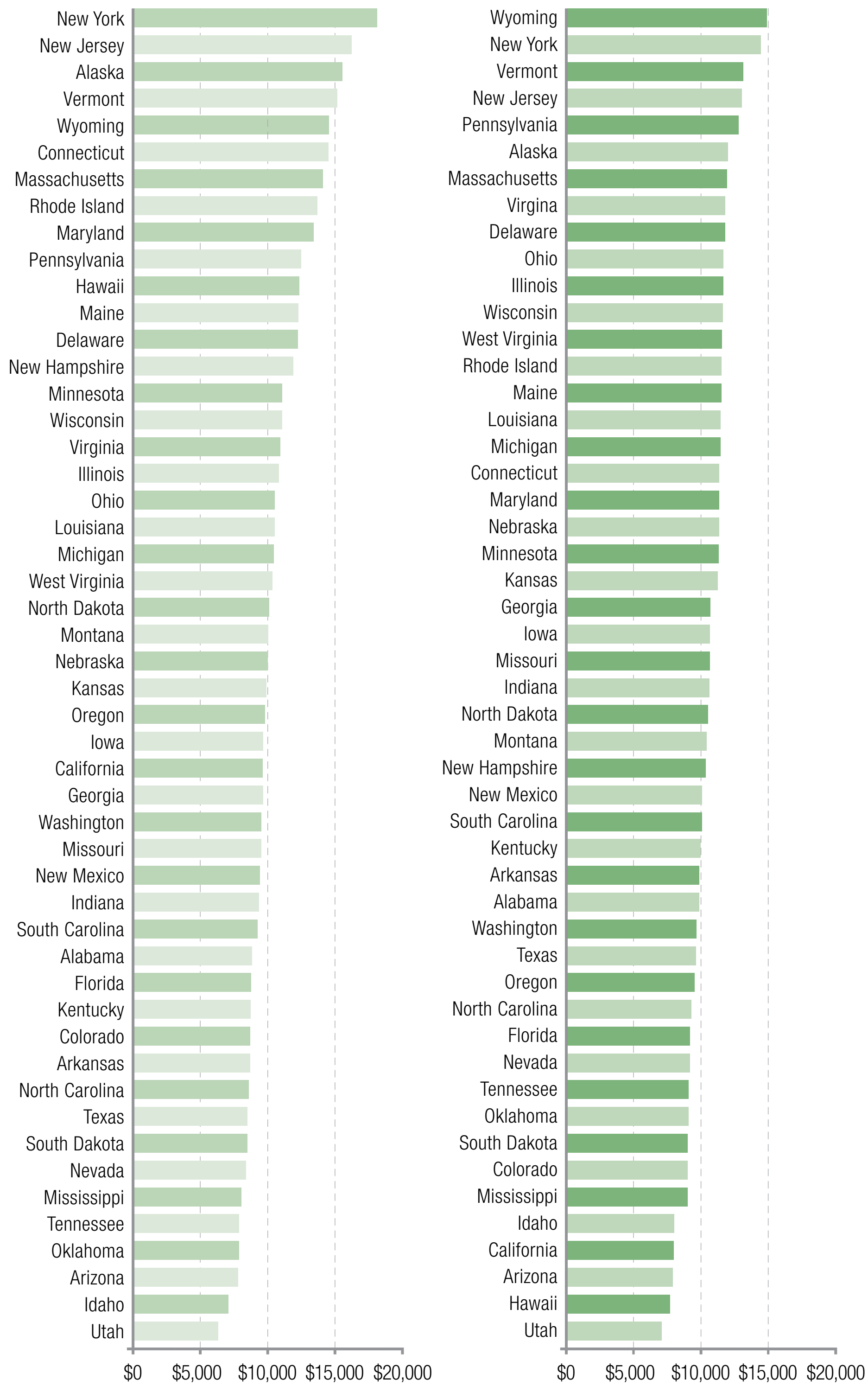
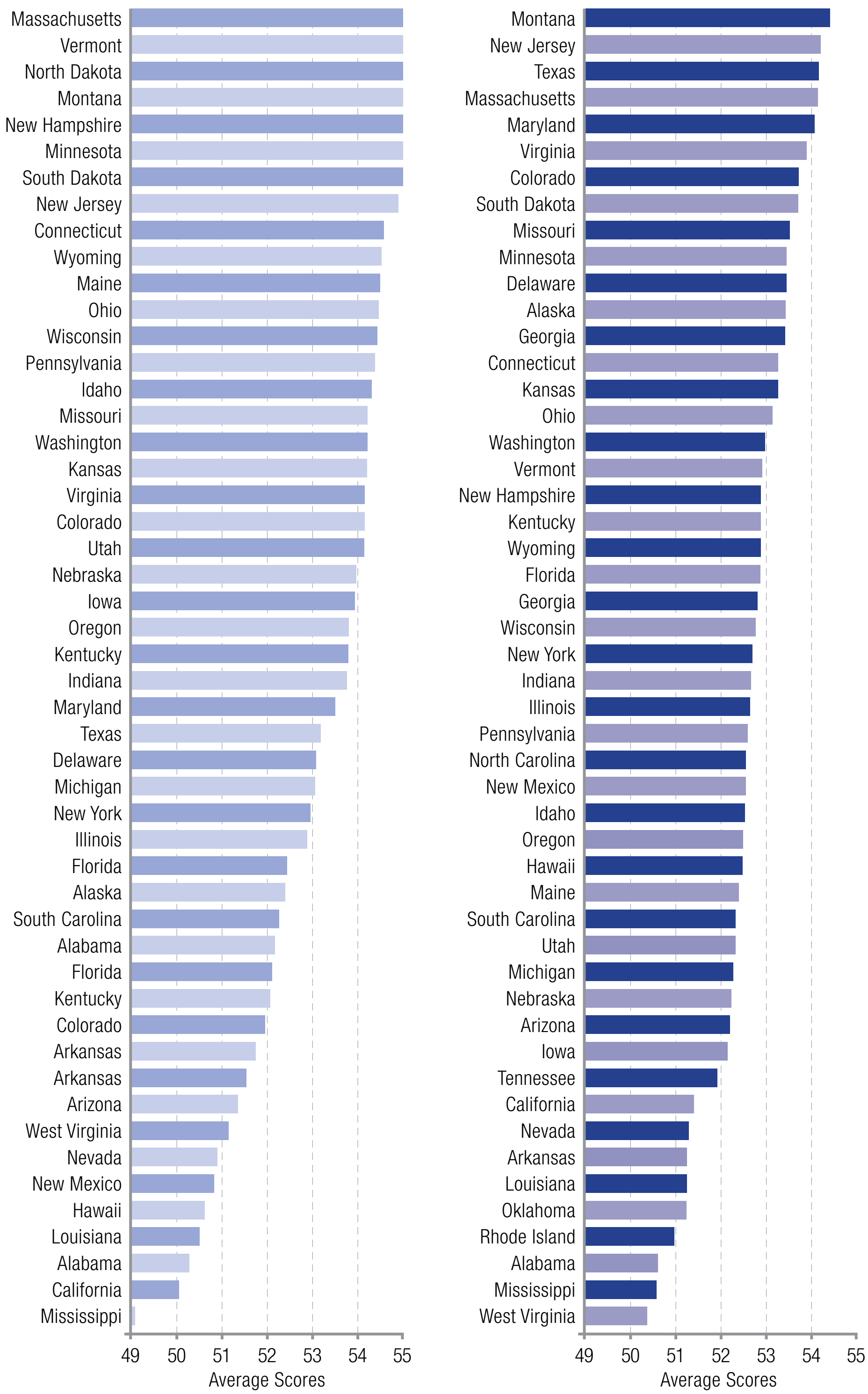


EXHIBIT 10

Getting Demographics Right

In rankings of eighth graders' average test scores across math, reading and science, failing to account for demographic differences favors states with large white populations (*left*). Setting the demographic mix for all states at the national average yields a more accurate measure of educational quality among states (*right*).



do a lot more than make telephone calls. Users routinely send and receive e-mails and texts, surf the Internet, read documents, play games and music, use GPS to find directions and take photographs and videos.

In the 1980s, nobody could have had a portable device that did all this—not even the richest person in the world. Today, anyone can buy an Apple iPhone 4 for $499 (no contract), the equivalent of 25 hours of work at the average wage rate (*Exhibit 11*). More than 90 percent of American adults now carry a cell phone, making it another quintessentially middle class product.

The clunky cell phone evolved into the sleek smart phone because markets focused the hard work and creativity of thousands of workers at dozens of companies on competing for the consumer's dollar. These enterprises knew they'd prosper by making better and cheaper products. Just as important, they knew they'd go out of business if they didn't do their best for the consumer.

Imagine for a moment that government had a telecommunications monopoly in the early 1980s. Had the bureaucrats in charge conceived of the cell phone, they would have seen no gain in introducing a product that even consumers didn't know they wanted.

If this barrier were overcome, more would have followed. Rigid rules would have hamstrung the product's development. The bureaucrats' priority would have been protecting jobs associated with land lines and pay phones. Technology would have advanced at a snail's pace—if at all. Phones would have been "standard government issue," probably more like the Motorola of 1984 than today's iPhone. A mania for fairness would have dictated equal access to cell phones, so we'd face the hidden costs of queues and black markets.

Think this is fanciful? Mail delivery teaches us a lot about government-run ventures. The U.S. Postal Service operates as a monopoly in delivering letters and other types of mail. As a business, it has lost money for years, including $16 billion in 2012. Unions and political meddling stand as obstacles to finding better ways of doing things. USPS customers end up paying higher prices for curtailed services—not a great endorsement of public enterprises.

Where they can, private companies have shown the USPS how to do it better. Founded by Fred Smith in 1971, FedEx developed the technology for an efficient air and ground network to deliver packages overnight, eventually grabbing a large share of the market while making a profit. FedEx's success forced the USPS to initiate its own overnight delivery, a reminder of the competition's power to deliver for the customer.

For the USPS, another competitive challenge arose as the Internet hit critical mass in the mid-1990s, when private-sector innovation put powerful computers and fast DSL lines into American homes. Instant and nearly free delivery of correspondence, electronic documents and money eroded the stodgy USPS's mail volume.

The superiority of the private sector over government arises from choice and competition. Markets offer choice by giving individuals the power of "no." They can reject companies that don't offer the right product or price. Markets provide competition that gives producers powerful incentives to offer the best possible products at the lowest prices, or lose out to others who do.

Government fails because it replaces choice and competition with the "take it or leave it" diktat of politicians and bureaucrats. They decide what people ought to have—one size fits all. Government wallows in red tape, resists change and protects entrenched interests.

Markets reward success with profits and greater market share; they penalize failure with losses and bankruptcy. When governments take control, they penalize individual success with higher taxes. On the spending side, failure often gets rewarded with a bigger subsidy.

Skeptics concede that markets work for cell phones and other consumer products, but they say education is different, too important to be left to the market. America's colleges expose this canard. Students can choose to study anywhere in the country, and colleges compete fiercely for students. The result: U.S. higher education is the best in the world, suggesting choice and competition will make our elementary and high schools less like the USPS and more like the iPhone, FedEx and our Internet companies.

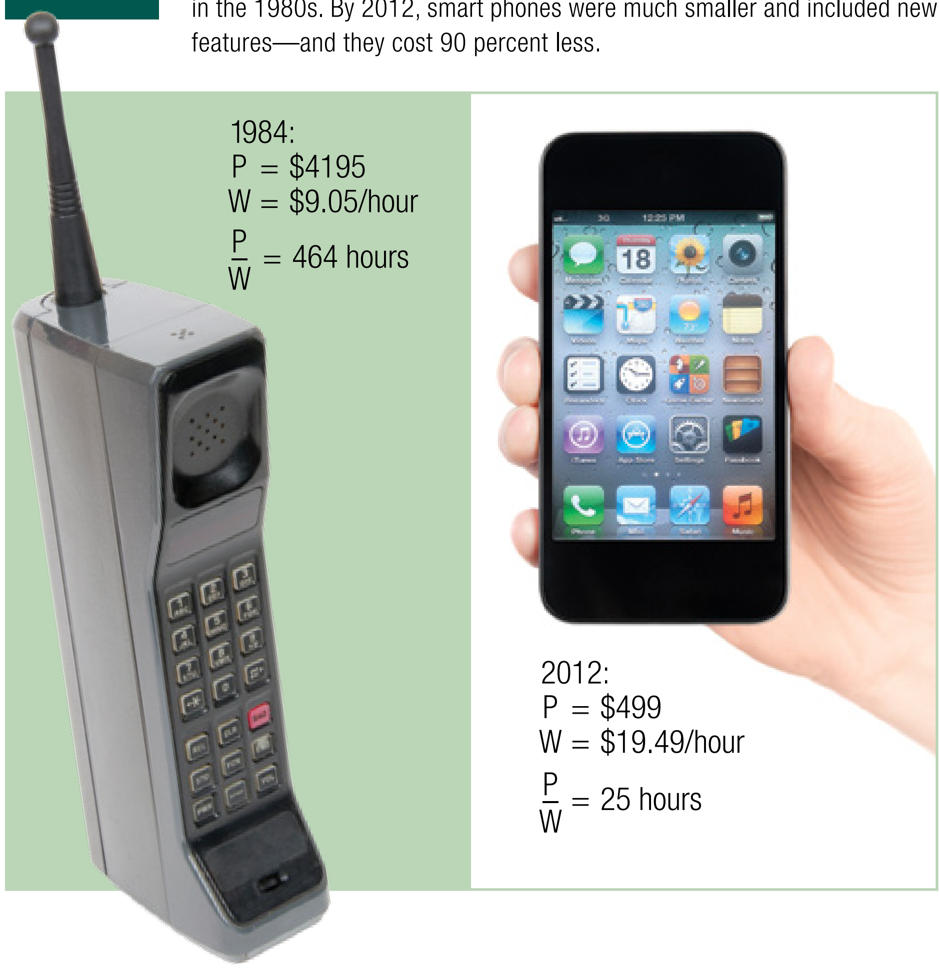
Make Schools Compete

America's public schools are older than the country itself, dating to the Boston Latin School in 1635. However, education had little economic value in a

EXHIBIT 11

Better and Cheaper

In the private sector, companies use innovation and efficiency to make profits. One example is the cell phone, which started bulky and expensive in the 1980s. By 2012, smart phones were much smaller and included new features—and they cost 90 percent less.



In His Own Words

Milton Friedman Famously Asked: Should Government Run Schools?

Milton Friedman first published "The Role of Government in Education" in 1955. At the time, he was a 43-year-old University of Chicago economics professor, a lonely voice for free markets in a profession dominated by Keynesian acolytes who saw government as largely benevolent.

Friedman revised the essay for *Capitalism and Freedom*, a 1962 book that reached out to a non-academic audience and presented ideas for smaller government—a volunteer military, freely floating exchange rates, abolition of medical licenses, a negative income tax and education vouchers.

Let's open the book to Chapter 6: *Formal schooling is today paid for and almost entirely administered by government bodies or non-profit institutions. This situation has developed gradually and is now taken so much for granted that little explicit attention is any longer directed to the reasons for the special treatment of schooling even in countries that are predominately free enterprise in organization and philosophy. The result has been an indiscriminate extension of government responsibility.*

Education can be intrinsically rewarding, and additional years of schooling raise incomes—so families have plenty of incentive to educate their children. Friedman recognized two common rationales for public schools. First, education confers benefits to society above and beyond what it does for individuals. Second, there's the paternalistic concern—some parents will fail to educate their children.

According to Friedman, neither public externalities nor parental shirking means government should both finance and operate schools, with bureaucrats dictating where students enroll and what they study. Friedman pointed out that government monopoly leads to conformity, wasteful spending and pay scales that "attract the dull and mediocre and uninspiring."

This chapter of *Capitalism and Freedom* offers an education alternative that embodies the choice and competition inherent in market systems. Let's return to the text: *Governments could require a minimum level of schooling financed by giving parents vouchers redeemable for a specified maximum sum per child per year if spent on "approved" educational services. Parents would then be free to spend this sum and any additional sum they themselves provided on purchasing educational services from an "approved" institution of their own choice. The educational services could be rendered by private enterprises operated for profit, or by non-profit institutions. The role of government would be limited to insuring that the schools met certain minimum standards, such as the inclusion of a minimum common content in their programs, much as it now inspects restaurants to insure that they maintain minimum sanitary standards.*

Throughout his career, Friedman maintained an interest in school choice, founding the Friedman Foundation for Educational Choice in 1996. As his ideas evolved, Friedman even moved away from the necessity of public funding for schools, except for aid to poor families.

nation of yeoman farmers, and schools remained largely private until the 1840s.

It might have remained so if not for people like Massachusetts school superintendent Horace Mann, who started advocating universal public education as the best way to turn the nation's unruly children into disciplined, judicious citizens. His ideas lit a fire, and schools funded and operated by government grew decade by decade.

Public schools were entrenched in every corner of the United States when economist Milton Friedman, a future Nobel laureate, famously argued that the private sector could do better than government in educating America. In 1955, he laid out a plan to issue taxpayer-funded vouchers for each student, which families would use to pay for the schools of their choice *(see box, left)*.

Typically, Friedman was right and ahead of his time. Over the next six decades, the idea of incorporating market mechanisms into education has gained traction. A variety of school choice options have cropped up around the country—voucher programs, charter schools, tax deductions and rebates, tax credit scholarships, private schools, home schooling, on-line learning and educational savings accounts (*Exhibit 12*).

Vouchers combine public financing with private provision. They rely on taxpayer funding to allay fears that some families can't afford to send their children to school or that some parents won't spend money on education. Charter schools expand choice and innovation, but they remain creatures of government, constrained by rules and regulations.

The alternatives to traditional public schools differ in many ways, but they all discard the idea of government dictating where students go to school, how money is spent and what's

EXHIBIT 12

Free to Choose

Most American students still attend traditional public schools, paid for by taxpayers and run by government. However, an increasing number of alternatives based on school choice have emerged in recent years. The following gives a flavor of what's going on:

Vouchers

State or local governments issue vouchers to parents, who use the money to pay at least a portion of the expenses of sending their children to private schools. Most voucher programs are small, often targeting at-risk students or those with special needs. Some form of Milton Friedman's concept underlies 18 programs in 12 states and the District of Columbia. An estimated 104,000 students are receiving vouchers. Mississippi, New Hampshire and Virginia passed voucher laws in 2012.

Vouchers: Milwaukee, Wis.

Begun in 1990, Milwaukee's Parental Choice System is one of the nation's oldest school voucher programs. Families earning up to 300 percent of the federal poverty line ($69,150 for family of four in 2013) are eligible to receive vouchers to attend any participating private school in the state. Average voucher value is about half of Wisconsin's overall spending per pupil. In 2012-13, the program covered 24,027 students.

Vouchers: Indiana

In 2011, Indiana launched the Choice Scholarship Fund, the nation's broadest voucher program. Eligibility extends to 530,000 students, nearly half of the state's total. In 2012-13, the vouchers' average value of $4,091 covered about 43 percent of Indiana's overall spending per pupil. The number of participants rose from 3,919 students in the first year to 9,324 in the second.

Charter Schools

Minnesota passed the first charter school law in 1991. While still publicly funded and expected to meet state standards, charter schools are free of many of the worst aspects of the educational bureaucracy and unions. Unshackled, they create competition and incentives to excel. Students and their families choose where to enroll; the schools themselves decide on hiring, firing and compensating teachers. Today, 2.3 million students attend 6,000 charter schools in 42 states and the District of Columbia.

Charter Schools: New Orleans and Los Angeles

Before Hurricane Katrina in 2005, New Orleans' public schools were a dysfunctional mess. After the devastating storm, the city and state began to rebuild the educational system from the ground up, encouraging charter schools. In 2011-12, 76 percent of New Orleans' students attended charters, well above second place Detroit and Washington, D.C., both at 41 percent. In 2011-12, Los Angeles led the nation in the total number of charter schools students at 98,576, up 24 percent from the previous year.

Tax Deductions and Credits

Parents who send their children to private schools still pay taxes to support public schools. Six states offset this financial burden by giving individuals tax deductions and credits for tuition and other private school expenses. About 847,000 people are receiving this benefit. Fourteen states give deductions and credits to companies and others who fund scholarships that are helping 151,000 students attend private schools.

Tax Policy: Florida

The Tax Credit Scholarship Program, created in 2001, grants dollar-for-dollar credits on corporate income taxes and insurance premium taxes for donations to nonprofits that provide scholarships to private schools for low-income and foster-care children. The scholarships can be worth up to $4,106—75 percent of which must go toward tuition, with the rest for textbooks and transportation. The number of students receiving benefits rose from 10,549 in 2004-05 to 50,821 In 2012-13.

Other Alternatives to Public Schools

Americans are increasingly attracted to educational options that bypass the public schools. In the United States, 34,000 private schools enroll more than 6 million students—even though parents still pay taxes for public schools. An additional 1.5 million students are home-schooled. Distance learning has emerged as another option, with 250,000 K-12 students enrolled in full-time Internet programs in 2010-11. Arizona instituted the first educational savings account in 2011, reaching 362 families.

What Adam Smith Knew

Published in 1776, *Wealth of Nations* is the most influential book in the history of economic thought. In it, Adam Smith anticipated the case for school choice.

Public schools were rare in Smith's day—but parents wanted to educate their children and teachers wanted to get paid for it. Passages in *Wealth of Nations* describe how different ways of educational funding shaped incentives.

A leading light of the Scottish Enlightenment, Smith knew the renowned universities in Glasgow and Edinburg, where professors depended on fees and honoraria paid by students and their families. This created a "rivalship of competitors … all endeavoring to jostle one another out of employment." Each professor's well-being was tied to his reputation as a teacher, spread by students' favorable reports; the best prospered "by the abilities and diligence with which he discharges every part of his duty."

Another funding system dominated England—central authorities paid teachers fixed salaries. Smith saw the corrupting incentives. He described a contagious neglect of duty, perpetuated by subservience to higher authority. "In the university of Oxford," he wrote, "the greater part of the publick professors have, for these many years, given up altogether even the pretense of teaching."

In more modern terms: Tying funding to the student rather than the school and letting loose competition will improve education. And that's the essence of school choice.

being taught. Instead, students and their parents pick the schools. Money goes with the student. Schools survive and prosper by doing a better job of educating; if they don't deliver, the students will find another school, taking the money with them.

Does school choice work? To find out, the Friedman Foundation for Educational Choice examined the best empirical research. In 22 of 23 studies, greater choice led to better overall academic outcomes, with the other showing no impact. Eleven studies show improved educational performance for participants—and no studies have found a negative impact. Six studies indicate school choice saves money for taxpayers. No studies found that school choice increases racial segregation.

Students will be better served in private schools run like businesses. There's no reason to shy away from what this means: operating for profit, replacing principals with CEOs, paying good teachers more, firing bad teachers, giving schools freedom to innovate in instruction methods and curriculum, letting new schools enter the market, allowing bad schools to fail, encouraging successful schools to take over unsuccessful ones, getting rid of unions that protect bad teachers and stifle change. A private school system gets the incentives right by rewarding better teaching and increasing variety in education—both will help more students to find a path to success *(see box above)*.

In state-by-state polls, the Friedman Foundation finds considerable public support for school choice, but the movement still faces obstacles, starting with the tyranny of the status quo. Change comes hard, and public schools' defenders play on sentiment and suspicion. The legion of rent-seekers—the public school bureaucrats and unions—see school choice as a threat, and they use their political clout to keep school choice initiatives small and limited. Make no mistake: they're fighting to protect their own interests, not students' well being.

The future of America's middle class depends on overcoming these obstacles. It starts with culture—getting Americans to grasp the power of choice and competition in creating quality education. Culture shapes politics, which changes policy. We must throw off the culture of fear that frustrates challenges to public schools—a fear manufactured by the education bureaucracy itself.

The United States can't go back to the middle class of the Industrial Age. We must move forward with private schools that turn out students with the knowledge they need for today's well-paying jobs. Rebuilding America's middle class will require capitalism in the classroom.

W. Michael Cox is director of the William J. O'Neil Center for Global Markets and Freedom (wmcox@cox.smu.edu).
Richard Alm is writer in residence at the center (ralm@cox.smu.edu).

Notes and Data Sources

Exhibit 3:
Surest Way to the Middle Class
Source: United States Department of Commerce, United States Census Bureau, Current Population Survey. Available at: census.gov.

Exhibit 4:
Less Brawn, More Brains
Source: United States Department of Commerce, Bureau of Labor Statistics. Available at: bls.gov.

Exhibit 5:
Little to Brag About
Source: Organization for Economic Cooperation and Development, Programme for International Student Assessment, 2009 PISA Database. Available at: oecd.org.

Exhibit 6:
Not Ready for College
Panel 1 Source: Organization for Economic Cooperation and Development, Programme for International Student Assessment, 2009 PISA Database. Available at: oecd.org.
Panel 2 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 7:
Education's Bottom Line
Panel 1 Source: Andrew J. Coulson, director of the Cato Institute's Center for Educational Freedom.
Panel 2 Source: Friedman Foundation for Educational Choice, Indianapolis, Ind. Available at: edchoice.org.

Exhibit 8:
Demographic Dilemma
Source: United States Department of Education, National Center for Education Statistics. Available at: nces.ed.gov.

Exhibit 9:
Getting Spending Right
Source: United States Department of Education, National Center for Education Statistics. Available at: nces.ed.gov.

We adjusted each state's spending per pupil by a state-level cost-of-living measure produced by the Missouri Department of Economic Development, Missouri Economic Research and Information Center. Available at: missourieconomy.org.

Exhibit 10:
Getting Demographics Right
Source: United States Department of Education, National Center for Education Statistics. Available at: nces.ed.gov.

The NCES tests 4th, 8th, and 12th grade students in civics, economics, geography, mathematics, music, reading, science, U.S. history, visual arts, vocabulary and writing. Data for all but math, reading and science are irregular and not widely available across states.

Scores are provided for whites, blacks, Hispanics, Asians, American Indian/Alaska natives, native Hawaiian/other Pacific islanders and other (two or more races combined). Only data for whites, blacks and Hispanics are widely available across states. They cover 93.2 percent of the student population.

Raw math and reading scores go from 0 to 500; science scores go from 0 to 300. For averaging, we converted all of them to a 0 to 100 scale. At the time of our study, the data for 2009 were the most complete.

Standard data imputation techniques were used for the missing observations, with help from SMU economics professor Tom Fomby.

Exhibit 11:
Better and Cheaper
Source: Wage data from United States Department of Commerce, Bureau of Labor Statistics. Available at: bls.gov. Price data: 1984 phone—Motorola Inc; 2012 phone—Apple Inc.

Exhibit 12:
Free to Choose
Source: Information comes from a state-by-state database maintained by the Friedman Foundation for Educational Choice, Indianapolis, Ind. Available at: edchoice.org.

We thank O'Neil Center research associate Kathryn Shelton for her help on this project.

Methodology

On Pages 9 and 10, the discussion of spending and school quality relies on regression analysis conducted by the authors. A simple regression with overall students' test scores (S) averaged across math, reading and science as the dependent variable indicated a positive and significant coefficient for expenditures per pupil (E), suggesting that spending on education improves students' scores.

To test for the robustness of this result and the possibility of a spurious correlation involving spending and other variables, we adjusted spending for cost of living differences among states and included a state-level COLA-adjusted income (I) among the explanatory variables. The regression yielded coefficients (and t-statistics) of 0.066I (2.10) for I and 0.097 (1.30) for E. The results indicate COLA-adjusted per capita income is significant at the 95% level in explaining the variation in students' scores across states. The hypothesis that more school spending raises students' scores is rejected.

Test scores vary by demographic group, and states differ widely in the composition of student populations. To obtain a standardized measure of student scores across states (S*), we multiplied average scores across math, reading and science by their national student population weights—0.5934 for whites, 0.1770 for blacks and 0.2296 for Hispanics. We also introduced a third explanatory variable—the percent of population age 25 and over that's college educated (C)—to allow for the possibility that parents' higher education is the driving factor behind both higher incomes and higher student scores. The results of the regression referred to on Page 10 are (t-statistics in parentheses):

$$S^* = \underset{(40.01)}{47.04} + \underset{(0.245)}{0.018E} + \underset{(1.963)}{0.060I} + \underset{(4.756)}{0.115C}.$$

The spending per pupil variable (E) has no significance in explaining students' performance. Both income and higher education are significant at the 95 percent level. We also ran separate regressions with spending, income and higher education as explanatory variables for each of the three subjects—math, reading and science—and each of the three demographic groups—blacks, whites and Hispanics. In no case was the spending variable significant. The results prove that spending per pupil is not a factor in raising test scores.

A Conversation with Jerry Fullinwider

Meet a Long-Time Champion for Economic Freedom

After growing up in Highland Park, Jerry Fullinwider graduated from SMU in 1951, and then served as a naval officer in Japan and Korea until 1954.

He left his Dallas job in 1964 and moved his young family to Midland, out in West Texas, where he saw the chance to start his own oil company as an independent operator. He founded V-F Petroleum, Inc., still in business today.

In 1989, Fullinwider saw opportunity again after meeting Soviet oil officials in Houston and finally responding to their invitation to do business in the Soviet Union. Soon afterward, Fullinwider's company was on its way to developing oilfields in southern Russia—a venture that continued for 18 years. HKN Energy Ltd., his company, is now doing exploratory drilling in the Kurdistan region of northern Iraq.

Some business leaders are quite happy to make money in the American free-market system, but they won't bother to defend it. That's not Jerry Fullinwider. In 1961, he helped found the pro-free enterprise Institute for Humane Studies, now at George Mason University, and he has served on the IHS board for all of its 52 years. In 2011, his family honored Fullinwider's dedication to free markets with an endowed chair in economic freedom in the O'Neil Center.

At the ripe old age of 84, Fullinwider couldn't pass up one more call to serve the cause of economic freedom—so this year he agreed to become chairman of the O'Neil Center's Advisory Board (see Page 20).

Q: How did you discover your passion for economic freedom?

A: When I was in high school, my father gave me a synopsis of the Wagner Act, a New Deal labor law. As I read the unfair, un-American nature of that document, it was difficult for me, an idealistic American youth, to believe it was the law of the land. I have been very wary and untrusting of big government ever since and have looked for ways to support limited government and economic freedom.

Q: What did you hope to accomplish in helping start IHS?

A: I met Dr. F. A. "Baldy" Harper at a central Texas ranch, where several young Dallas professionals gathered to discuss free-market history and ideas. He explained his vision of an institute devoted to research and publishing of historical principals of economic freedom. After we had known each other and corresponded for some months, he invited me to be a member of the founding board of IHS. I wasn't sure what resources I had to offer IHS, but after catching Baldy's vision, I wanted to do what I could to further establish the principals of liberty and freedom in this country. IHS has gone on to be quite successful as one of the most influential "think tanks" in the country.

Q: What drew you to the O'Neil Center?

A: As a graduate of SMU, I was aware there was very little emphasis among the faculty and curriculum on free-market history and economics. When I heard of the O'Neil Center, I was enthused—at long last, some serious scholarship was going to be pursued by free-market adherents on the SMU campus.

Q: What are your hopes for the O'Neil Center?

A: I hope the O'Neil Center will continue to grow by adding additional scholars, interacting with more students, publishing additional original works and establishing itself as a beacon for individual liberty and free-markets in North Texas and beyond.

Q: Seeing the world today, do you get discouraged about the future of capitalism?

A: Capitalism, properly understood, is what naturally develops over time when people are left free to deal in trade and commerce without government intervention. Real capitalism is not a system that is forced from the top down on the people and maintained by force—like the various forms of socialism, fascism, communism, etc. It is a system that naturally occurs when people are left free to make their own choices about life and how to live it. The survey of the world's governments today, including our own, would not give one a very hopeful idea of the future of capitalism. But knowing mankind's innate desire for individual liberty, I have the sure belief that when economic freedom breaks the shackles of government tyranny, at home and abroad, capitalism will arise. Like human freedom, it really is part of the natural order.

2012: Year in Review

The William J. O'Neil Center for Global Markets and Freedom formed an Advisory Board in 2012, bringing together a group of business and civic leaders to help guide the center's research and growth.

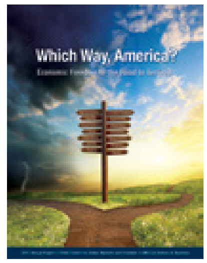
Jerome M. Fullinwider, an SMU grad and independent oilman, serves as the board's chairman (*see interview, facing page*). He's joined by vice chairman William Spears, founder of Cenergistics, an energy conservation advisor. Los Angeles-based William J. O'Neil, the center's founder and namesake, is chairman emeritus. The graphic on Page 20 introduces the complete O'Neil Center Advisory Board.

"I'm amazed at the group Jerry Fullinwider put together—all highly successful men and women who believe in the American free enterprise system," O'Neil Center Director W. Michael Cox said. "I look forward to working with this board to make the O'Neil Center an even greater success."

Founded in 2008, the O'Neil Center continued to build its reputation as a voice for free-market economics in 2012. Joining Cox at the center are SMU Cox Dean Albert W. Neimi, professors Dwight R. Lee, Robert Lawson, Maria Minniti and Michael Davis, writer in residence Richard Alm and research associate Kathryn Shelton.

The O'Neil Center published its third annual report, highlighted by the essay *Which Way, America? Economic Freedom or the Road to Serfdom*, written by Cox and Alm. It presents the stark choice facing the United States today: Greater economic freedom or bigger government, the former bringing prosperity and the latter economic decline.

The essay documents how market incentives encourage people to work, save, invest, innovate, start businesses and take risks. These good choices grow GDP. The essay warns that high taxes, rising entitlements and excess regulation foster negative incentives that sap productive activity, leading to lower living standards.



In September, Lawson and his co-authors released the 2012 edition of the *Economic Freedom of the World* report. The ongoing project unites researchers from around the world in compiling an extensive database on more than 140 countries. The report was particularly newsworthy because U.S. economic freedom fell for the fourth straight year in 2010, dropping the country to No. 18, its lowest ranking the index's history. Press coverage included "Freedom is the Key to Prosperity," an op-ed published in the *Philadelphia Inquirer* by Lawson, James Gwartney and Joshua Hall.

The O'Neil Center Speakers Series held its inaugural event in February, featuring Hoover Institution economist Russell Roberts, the host of the weekly podcast *EconTalk*. At a reception hosted by Ross and Sarah Perot, Roberts spoke to about 100 guests about public debt, out-of-control spending and the tricks politicians use to expand the size of government. The next day, Roberts held a seminar on teaching economics for SMU Cox School of Business faculty members.

The Speakers Series, funded by a donation from the executives at Andrews Distributing, a Dallas-based beverage company, continued in April with Harvard Business School's Michael Jensen. The O'Neil Center partnered with the George W. Bush Institute for a luncheon at SMU Cox's Collins Center. Later in the day, about 200 people attended Jensen's public lecture on the power of integrity in the marketplace.

In October, the Speakers Series and Bush Institute co-hosted a luncheon with Roberto Salinas Leon, president of the Mexico Business Forum. In a talk titled "Mexico and the New Pena Nieto Administration: The Challenges Ahead," Salinas Leon gave a surprisingly upbeat portrait of grass-roots dynamism percolating in Mexico's economy, led by a generation of better educated and ambitious young people.

O'Neil Center Conference

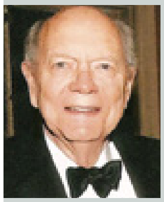
In October, the O'Neil Center hosted its fourth annual conference under the banner of "The Future of Economic Freedom." More than 300 business leaders and students gathered in the Collins Center for the half-day program, highlighted by luncheon keynote speaker John Mackey, co-founder and co-CEO, Whole Foods Market Inc.

Mackey pointed to capitalism's record over the past 200 years—a 1,000 percent rise in per capita income, huge reductions in abject

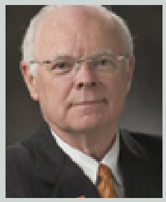
The William J. O'Neil Center for Global Markets and Freedom

ADVISORY BOARD

These men and women serve on the O'Neil Center's inaugural Advisory Board. To help us get acquainted, we asked members to name a favorite book that inspired their passion for economic freedom.



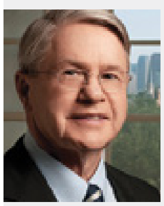
Jerome M. Fullinwider
Chairman
Founder and Vice Chairman, HKN Energy, Ltd.
Favorite Free Market Book:
The Mainspring of Human Progress by Henry Grady Weaver



William S. Spears
Vice Chairman
Chairman and Founder, Cenergistic
Favorite Free Market Book:
Grand Pursuit: The Story of Economic Genius by Sylvia Nasar

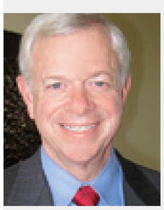
William J. O'Neil Chairman Emeritus
Chairman and Founder, Investor's Business Daily
Favorite Free Market Book:
Free to Choose: A Personal Statement by Milton Friedman and Rose Friedman

Allie Beth Allman
Owner and Chief Executive Officer, Allie Beth Allman & Associates
Favorite Free Market Book:
The 4% Solution: Unleashing the Economic Growth America Needs, Published by the George W. Bush Institute

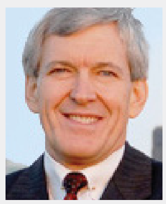


Michael Boone
Founding Partner and Attorney, Haynes & Boone
Favorite Free Market Book:
Capitalism and Freedom by Milton Friedman

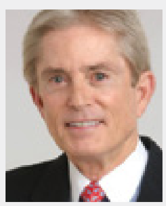
Todd Furniss
Managing Partner, glendonTodd Capital
Favorite Free Market Book:
Atlas Shrugged by Ayn Rand



Ronald Lazof
Managing Director, PrismAdvisors LLC
Favorite Free Market Book:
Wealth of Nations by Adam Smith

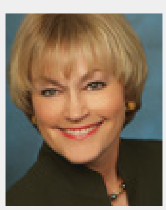


Thomas C. Leppert
Chief Operating Officer, Kaplan Inc.
Favorite Free Market Book:
Capitalism and Freedom by Milton Friedman



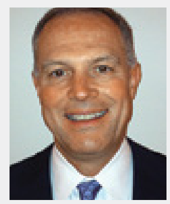
John D. McStay
Managing Partner and CFA, John McStay & Associates
Favorite Free Market Book:
The Elements of Investing by Burton G. Malkiel

Sarah F. Perot
President, Sarah and Ross Perot, Jr. Foundation
Favorite Free Market Book:
The Coffee Trader by David Liss



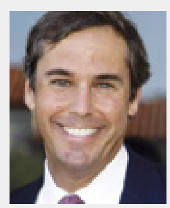
Gail Plummer
Chief Executive Officer and Co-founder, Altair Global Relocation
Favorite Free Market Book:
The Game-Changer by A. G. Lafley

Michael S. Rawlings
Mayor, City of Dallas
Favorite Free Market Book:
The Coming Jobs War by Jim Clifton



Eric M. Stroud
President, Hoak Fund, Inc.
Favorite Free Market Book:
Return to Prosperity by Arthur B. Laffer and Stephen Moore

James Von Ehr, II
Chief Executive Officer and Founder, Zyvex Labs, LLC.
Favorite Free Market Book:
The Economics of Freedom: What Your Professors Won't Tell You, Selected Works of Bastiat



Ray W. Washburne
Chief Executive Officer and Founder, Charter Holdings
Favorite Free Market Book:
Atlas Shrugged by Ayn Rand

Richard H. Wright
Chief Operating Officer, Advocare International
Favorite Free Market Book:
Good to Great by Jim Collins

poverty, longer life spans, greater political freedom, spreading literacy and more satisfying lives.

"Very curiously, despite the tremendous success of capitalism, it has what I call a very serious branding problem," he said. "Business is not seen as *good*. Instead, business is mostly seen as selfish, greedy, exploitative, fundamentally unethical."

Capitalism isn't better appreciated, Mackey said, because its defenders have responded to critics by justifying selfishness and greed as beneficial for society—the lesson of Adam Smith's fabled Invisible Hand.

"We will not win the argument as long as we concede the fundamental narrative that business is based on selfishness and greed and it's exploitative," he said.

Mackey urged a new narrative, based on the true ethical foundation of capitalism. Business success springs from a number of virtues—prudence, integrity, gratitude, temperance, love, forgiveness, justice, compassion, faith, courage, generosity, hope. "Without those things, you can't create a great organization," he said.

Mackey advocated more than a good public relations campaign. Under the banner of "conscious capitalism," he contends that businesses need to embrace purposes beyond just maximizing profits. Whole Foods, for example, tries to help people live healthier lives—a mission that inspires the company's employees.

"The difference that you are trying to make drives everything you do," Mackey said. "It matters to all of your stakeholders. It's your reason for being that goes beyond money. And yet, paradoxically, the purpose-oriented business makes more money."


John Mackey

Before Mackey's luncheon keynote, Cox set the stage with a presentation based on the choice between markets and socialism, the subject of *Which Way America?* Lawson followed with a review of the latest trends in the *Economic Freedom of the World* report, concentrating on the U.S. decline over the past decade.

The following summaries give some highlights from the presentations by other conference speakers:

Michael Strong, co-founder of FLOW, Conscious Capitalism Inc. and the Free Cities Institute: Ineffective legal institutions are a big reason poor countries remain poor. For example, it takes a lot of time and money to enforce contracts in many Third World legal systems—four years and more in places like India, Bangladesh, Guatemala and Afghanistan.

In most poor countries, huge obstacles block legal reform, Strong said. The free cities movement devised an alternative—enclaves allowed to operate under world-class law, governance and security. Freed from the morass of red tape and corruption, they will prosper. It's the next step up from the reduced taxes and regulations of the foreign trade zones that transformed Shenzhen in China and Dubai.

In 2011, Honduras authorized special development regions with their own laws, governance and security. A year later, Strong began working with the government to establish these zones. "I see a profitable way to make the world a better place," he said.

Veronique de Rugy

Veronique de Rugy, senior research fellow at George Mason University's Mercatus Center: Competition isn't just a force for good in the private sector. Over the past 30 years, tax competition among nations has reduced the average global rates from 67 percent to 41 percent for top individual income taxes and from 48 percent to 24 percent for corporate taxes. Other types of taxes have been reduced, too.

"I want governments to compete with each other as ferociously as possible," De Rugy said, "because I know this is the best chance we have to actually get good policies. It is true in the realm of regulation, taxes and all the other areas."

Politicians and bureaucrats want to tax and spend, so they loathe tax competition. De Rugy warned of an attempt to establish an OPEC-like tax cartel through international rules that harmonize tax rates, exchange data, enforce other nations' tax laws, punish tax avoidance and limit capital mobility.

Benjamin Powell, director of the Free Market Institute at Texas Tech: Many activists who live in First World comfort see Third World sweatshops as an evil to be purged from the Earth. Powell won't deny the factories' low pay, long hours and risky working conditions, but he said outlawing sweatshops would just make workers in poor countries worse off.

Sweatshop workers feel fortunate to have their jobs, Powell said, because garment factories offer better pay and working conditions than the most likely alternatives—subsistence farming, begging, scavenging and informal service sector jobs.

Activist campaigns and labor laws won't help sweatshop workers, Powell said. Poor countries need to import capital and technology and build labor skills. Throughout history, factories condemned as sweatshops have been the first rung on the ladder of economic development. "What activists try to do undermines this process," Powell said.

Michael Clemens, senior fellow at the Center for Global Development: Want to make the world richer? Eliminating all barriers to trade and capital flows would add $2.8 trillion to world GDP; however, a modest reduction in barriers to labor mobility would add more than $4.2 trillion.

Clemens portrayed U.S. immigration laws as a massive intervention in the labor markets, a costly morass of red tape aimed at keeping foreigners from

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 taking low-paying jobs few Americans want. "What we have is Washington micromanaging the hiring decisions of a constellation of employers … in all kinds of industries they couldn't possibly understand," he said.

Clemens urged the United States to consider alternatives guided by prices —in effect, charging admission to the U.S. labor market. A market-based system would be more transparent, flexible and efficient; it would favor the immigrants who would add the most to the U.S. economy.

Christopher Coyne, professor at George Mason University's Mercatus Center: The military now dominates U.S. foreign policy, routinely taking over humanitarian, development and nation-building projects. According to Coyne, using the armed forces in social engineering rests on the same misguided premise as Soviet-style central planning—the belief that elites know enough to decide what's best for society.

That's just not so. Time and again, Coyne said, interventions founder on waste and corruption, information snafus and competing principles and goals. These pitfalls plague government action—so why expect the military, organized on the same basis as the woefully inefficient U.S. Postal Service, to accomplish tasks far more complex than delivering mail in situations far more hostile than the United States?

Interventions frequently degenerate into unintended consequences—from dictatorship to humanitarian crises. "Anytime we intervene abroad, we can't just do one thing," Coyne said. "It's going to have ripple effects, long-lasting ripple effects that oftentimes are going to be negative."

Videos of all presentations from the O'Neil Center's four conferences are available at www.oneilcenter.org.

Spreading the Word

Teaching remains a focus for O'Neil Center faculty. Courses covered economics for undergraduates and all three SMU Cox MBA programs. Niemi developed a new MBA course in the fall semester on the evolution of American capitalism, examining the country's economic history by major subject areas rather than chronologically.

Cox continued to lead the business school's ongoing Women's Economics and Finance Series, giving presentations on topics such as the next stage of American progress, how to make good money in a bad economy and fixing America's schools.

Davis traveled to Europe with the full-time MBA students and to Latin America with professional MBA students as a part of the Global Leadership Program, an initiative designed to teach SMU Cox students about the economic, social, political and cultural forces impacting the way business is conducted in the global marketplace.

In September, Lawson brought Professor Edward Lopez, BB&T Distinguished Professor of Capitalism at Western Carolina University, to SMU for a faculty seminar. Lopez discussed his new book *Madmen, Intellectuals, and Academic Scribblers: The Economic Engine of Political Change*. Lopez offered a straightforward economic framework for understanding the causes of political change.

Cox and Alm wrote "The Right Incentives for Economic Growth" for the *Austin American-Statesman*. The op-ed was based on the Cox and Alm chapter in *The 4 Percent Solution*, the Bush Center's first book. Cox gave a presentation at the book's July release event in Dallas, attended by former President Bush. *The 4 Percent Solution* also included Minniti's essay, titled "Female Entrepreneurship and Economic Growth."

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

Cox and Alm made the front page of *Investor's Business Daily* with "A Four-Year Legacy of Failure," a review of the Obama administration's economic policies. The two authors also wrote an *Investor's Business Daily* op-ed titled "Keynesian Stimulus Fails in Theory—and Reality." The article presented evidence that higher government spending actually raises unemployment.

Dallas' *D CEO* magazine published Cox and Alm illustrated articles on the Dallas area's booming technology, economic freedom's impact on job creation in Texas (*see facing page*), the state's quick return to peak employment and Texas CEO's rosy pay after adjusting for the state's lower cost of living.

Lee wrote "The Keynesian Path to Fiscal Irresponsibility for *The Cato Journal*. *The Freeman* published "Just Wait Until It's Free," a lament on the real cost of government benefits, co-authored by Lee and frequent collaborator J.R. Clark. The magazine also published Lee's "*Capitalism and Freedom*: A 50th Anniversary Tribute to Milton Friedman."

O'Neil Center faculty have emerged as popular analysts for a nation curious about Texas' economic success. In November, Cox and Alm wrote "A Big Texas Welcome to Californians" for Bloomberg/Businessweek. Lawson and Alm wrote a December op-ed for the *Dallas Morning News* on "Why Texas Ranks High for Economic Freedom."

Shelton co-authored three articles with economist Richard McKenzie. For the *Library of Economics*, they examined the benefits of free markets in organ transplants. *The Freeman* gave cover play to Shelton and McKenzie's "Hybrids and Hype," an article on the folly of policies that steer buyers to hybrid automobiles. In *Regulation* magazine, Shelton and McKenzie discussed the unintended consequences of stringent government rules on physical contact with children.

Shelton also wrote two online opinion pieces for *DoubleThink*—one presenting the case against banning same-sex marriage and another examining California's failed Proposition 31, which would have required food manufacturers to label their foods as genetically modified.

Lawson gave lectures on the *Economic Freedom of the World* report in a half-dozen U.S. cities, plus Germany, Mexico and the country of Georgia. At the Association of Private Enterprise Education conference in April, Lawson presented a research paper on "Economic Freedom and Labor's Share."

At the APEE meeting, Lee gave a talk titled "Too Inexpensive to be Inexpensive." In September, Lee spoke in Dallas on "Compassionate Voting and Economic Recovery." Two months later, he gave "An Economic Analysis of the Effects of Fair Trade" at the Southern Economic Association meeting in New Orleans.

The media regularly sought the expertise of faculty members. At the end of the academic year, both Cox and Davis were honored for being among SMU Cox's Top 10 in media interviews and citations.

Cox continued to be 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.

In August, the O'Neil Center redesigned its website, which now includes more faculty research and publications. Making the website easier to use and more appealing has helped attract more visitors and expand the O'Neil Center's influence.

The website redesign included a new Working Papers Series, an outlet for potentially important research on private enterprise and economic freedom. Working papers allow academics to share their latest research while going through the process of getting published in peer reviewed journals.

Texas Churn

In a slow recovery, **the state is still going strong.**

BY W. MICHAEL COX AND RICHARD ALM

CAPITALIST ECONOMIES RAISE LIVING STANDARDS THROUGH a process of constant change. New companies rise, offering consumers better and cheaper products. The competition sometimes drives existing firms out of business. All this churning creates new jobs and destroys old ones.

Mass production of automobiles, for example, meant new factory jobs but signaled an end to the horse and buggy trades. Robotics added jobs for computer programmers but idled many assembly-line workers.

To measure the churn, the Bureau of Labor Statistics compiles data on the private sector's gross job gains and gross job losses. They show a large, relentless flux roiling the labor market, something obscured by monthly reports that focus on net gains.

For the United States, labor turnover involved more than 27 million jobs in the most recent 12 months. The Texas churn affected nearly 2 million jobs over the same period.

The nation's job churn slowed from the 1990s, a decade of robust growth, into the 2000s, when the economy wasn't as strong. The churn ebbed further in the past few years of recession and weak recovery (see bottom chart).

Looking at 1992 to 2011, California and New York showed similar downshifts in job creation and destruction.

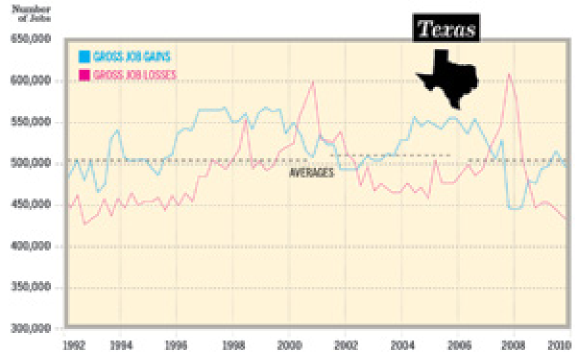
Retaining its vitality, Texas has stood out as an island of economic growth as the rest of the country has sputtered in recent years.

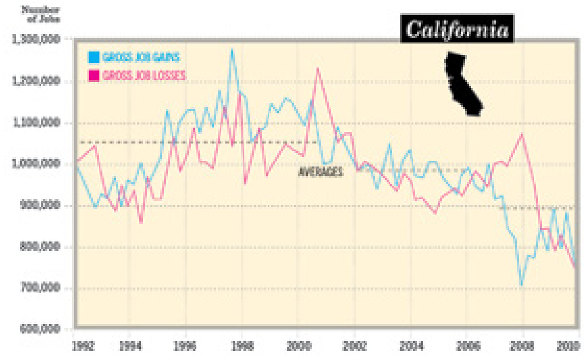
The Texas churn looks quite different (see top chart). In the past decade, the state has been creating and destroying the same number of jobs it did in the 1990s. Retaining its vitality, Texas has stood out as an island of economic growth as the rest of the country has sputtered in recent years.

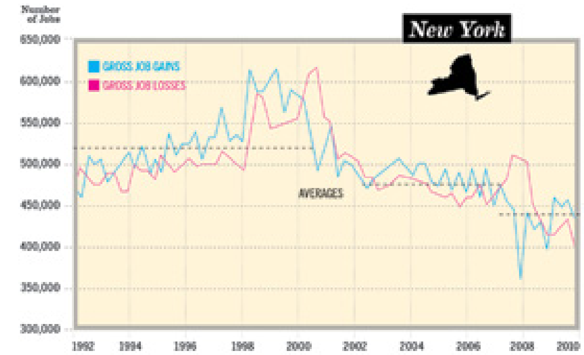
The reason for Texas' strong churn is clear: economic freedom. Simply put, the state lets its labor market work.

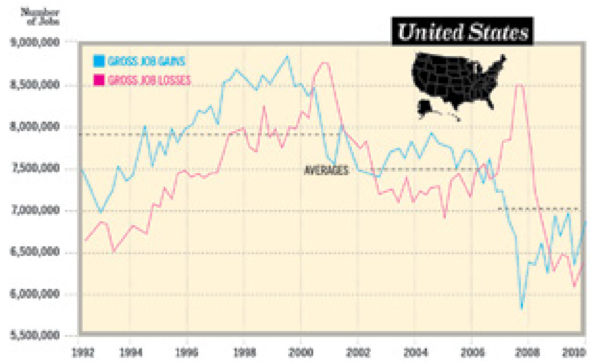
Compared to California and New York, Texas maintains fewer restrictions on hiring and firing, and it has lower rates of unionization. Economic freedom makes it easier to start businesses and expand them. The payoffs are growth and jobs.

Cox is director of the William J. O'Neil Center for Global Markets and Freedom at Southern Methodist University. Alm is writer in residence at the center. Research associate Kathryn Shelton contributed to this article.









Note: Latest data: through second-quarter 2011.

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