THE MPACT REPORT

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The Secret to Prosperous Cities

By W. Michael Cox and Richard Alm

Cities dominate America's economy. In 2017, the 25 largest U.S. metropolitan areas accounted for more than half of the nation's economic activity. The urban contribution rose to 65 percent for the top 50 cities and 75 percent for the top 100. Expanded to all 383 metropolitan statistical areas (MSAs), the share exceeded 90 percent.

These MSAs vary widely in growth, job creation and other measures of economic well-being. The construction cranes standing tall above the skyline of booming Dallas-Fort Worth (DFW) contrast with the dingy blocks of abandoned buildings in Rust Belt relics like Cleveland.

Why do some urban areas prosper and others struggle?

It's an important question because most of today's Americans live in cities, and they're more likely to work in the 21st Century's urban-based services and knowledge industries. The country will thrive only if its MSA's do.

In recent decades, economists developed powerful empirical tools to help us understand why some countries and states do better than others. The *Economic Freedom of the World* and *Economic Freedom of North America* reports consistently find faster growth, higher incomes and other positive outcomes in places that give markets and the private sector more room to operate.

This issue of *The MPACT Report* applies the same approach in searching for links between economic freedom and MSAs' prosperity. The conceptual case rests on solid ground: Densely packed urban areas provide a natural habitat for markets, where new ideas emerge, percolate, mutate and spread, allowing human creativity and cooperation to flourish. Out of that comes economic growth. Throughout history, most of humanity's progress has sprung from the perpetual churning of ideas and enterprises in the metropolitan milieu.

MSA ECONOMIC FREEDOM

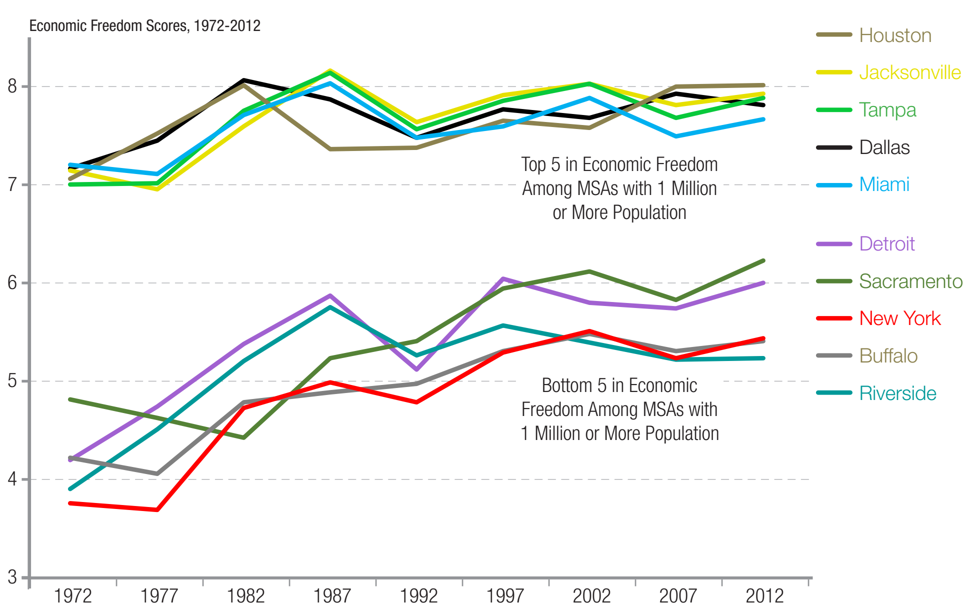
A few years ago, economist Dean Stansel, our colleague in SMU's O'Neil Center, adapted the well-documented methodology of measuring economic freedom to U.S. metropolitan areas. Using a range of data, he focused on three broad areas—size of government, taxation and other takings and labor-market freedom. The result is a single number that locates each MSA on a spectrum between 0 for the lowest economic freedom and 10 for the highest economic freedom.

Stansel just released an updated and expanded version of his MSA economic freedom index. It not only offers readings based on the most recent data (2012) but also extends the index back to 1972. The historical perspective allows us to treat economic freedom as a form of capital good, which delivers its benefits over time for MSAs that maintain a commitment to it.

Looking at the 50 MSAs with populations above 1 million in 2012, we see that commitment to economic freedom among the urban areas at the top of the index—Houston and DFW in Texas; Jacksonville, Tampa and Miami in Florida *(see chart below).* Places with low economic freedom scores have found it difficult to rise off the bottom, even though the Detroit, Sacramento, New York, Buffalo and Riverside (Calif.) MSAs are freer today than they were four decades ago.

Between Houston at the top and Riverside the bottom, the pecking order among the Top 50 sketches the rough

MSA Economic Freedom: Gaps Both Shrinking and Persistent



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pattern of urban economic freedom. Sunbelt MSAs skewed toward the top, with 16 of the 20 highest scores in 2012. In addition to the bigger MSAs already cited, high degrees of economic freedom were found in Richmond, Nashville, Austin, Oklahoma City and Orlando.

Washington, Baltimore and Boston stand apart; they're Northeast MSAs that rank highly on economic freedom. Scores are lower for other MSAs in the Northeast, Midwest and California. They take up 18 of the bottom 20 spots and include some of America's largest urban areas—New York, Los Angeles, Chicago, Philadelphia, San Francisco, Detroit, Minneapolis and San Diego.

MSAs differ in size, location, industrial base, demographics, education and many other factors that impact economic performance. In effect, urban American offers 383 different stories—far too many to tell individually.

For our analysis, we truncated the nation's urban areas at the 100 largest MSAs—from the 20 million people living in the tri-state megalopolis sprawling around New York City down to relatively isolated Spokane, Wash., and its 532,440 residents. We then divided the top 100 MSAs into five groups of 20 to reveal the connections between economic freedom and economic performance.

LET FREEDOM RING

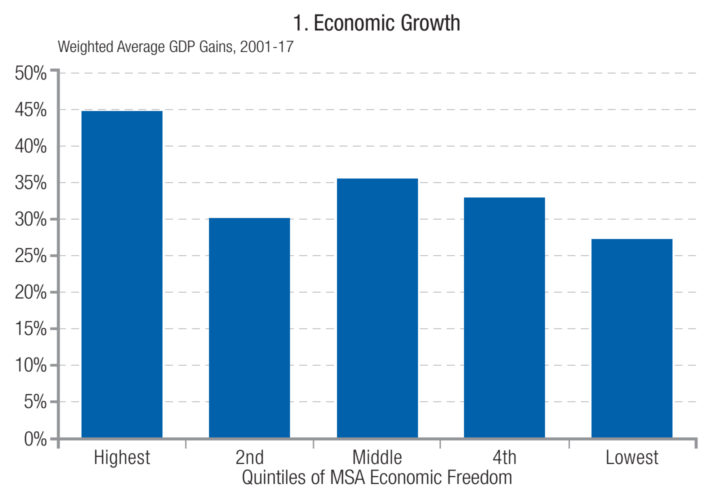
Let's start with growth. An MSA's economic pie expands when existing firms increase output, when entrepreneurs start new businesses and when companies and residents move into the MSA. A pro-market business climate should spur all three.

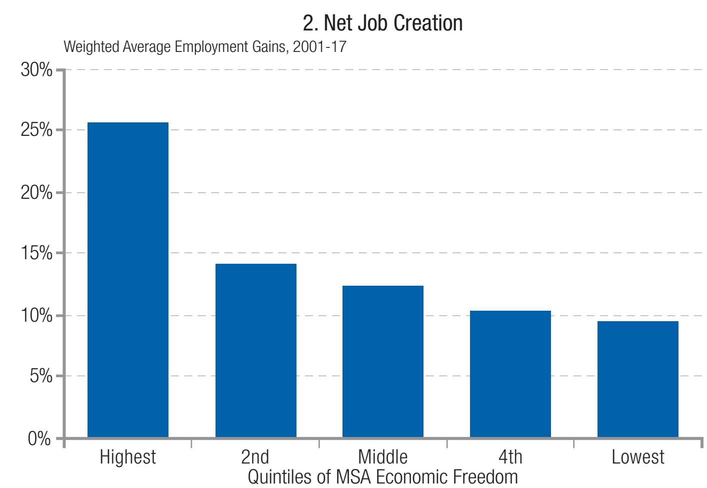
Since 2001, the 20 MSAs with the highest economic freedom had a weighted average gain of 45 percent in GDP, or more than 2.6 percent a year *(Chart 1)*. The 20 with the lowest economic freedom grew an average of only 27 percent, or about 1.6 percent a year.

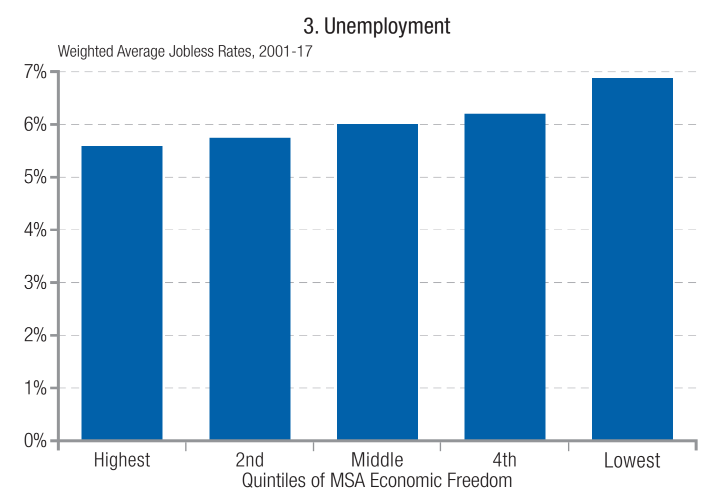
Faster economic growth almost always leads to more and better job opportunities. The Top 20 posted a weighted average employment gain of more than 25 percent from 2001 to 2017 *(Chart 2)*. Turning to MSAs with less economic freedom, we see net job creation fall off quite quickly, stepping down from about 14 percent for the second-freest group to just 9.5 percent for the MSAs in the lowest quintile.

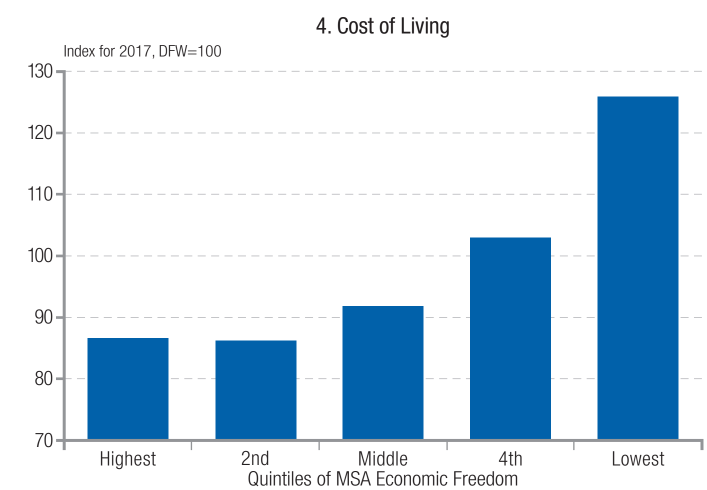
When job creation lags, it's usually tougher to find work. For the most economically free MSAs, the weighted average unemployment rate was 5.6 percent over the 17-year span *(Chart 3)*. There's a steady increase with each economic freedom quintile, culminating in 6.7 percent for the least free group. If these unemployment rates seem high by recent standards, remember that this period includes the Great Recession of 2008-09 and the slow recovery that followed.

These findings on output and labor markets are intuitive, all consistent with Adam Smith's proposition that economic freedom unleashes forces that increase









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wealth and well-being. Most of the time, faster growth also comes with an unwelcome side-effect—the erosion of living standard by higher inflation.

It's not so at the MSA level. Using our hometown of DFW for 2017 as the benchmark, we find that the cost of living (including taxes) was lowest in the two quintiles with the greatest economic freedom. From there, the average cost of living rises, with the least-free group 45 percent above the freest 40 percent *(Chart 4)*.

Many things may cost more in places with lower economic freedom—but housing makes up the biggest part of family budgets. Policies that restrict building crimp housing supply in the Northeast and West Coast MSAs with low freedom scores. Prices go up with demand. Freer MSAs make it easier to increase the residential inventory, so rents and housing prices don't rise as fast—even in places like Houston, where local economies and populations are growing rapidly.

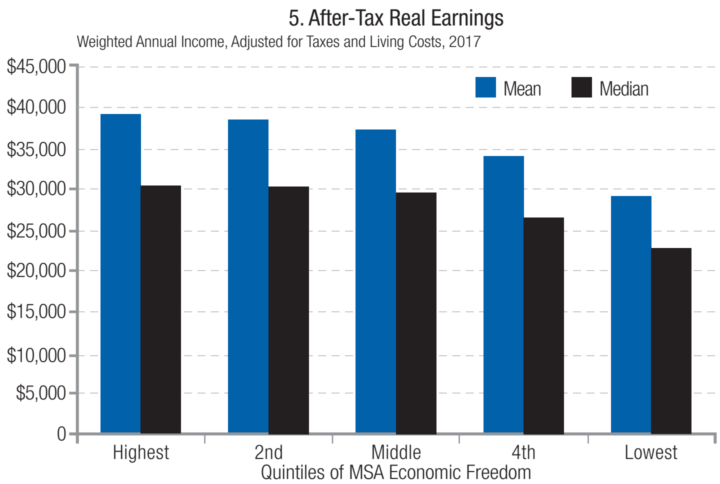
These findings on output and labor markets are intuitive, all consistent with Adam Smith's proposition that economic freedom unleashes forces that increase wealth and well-being.

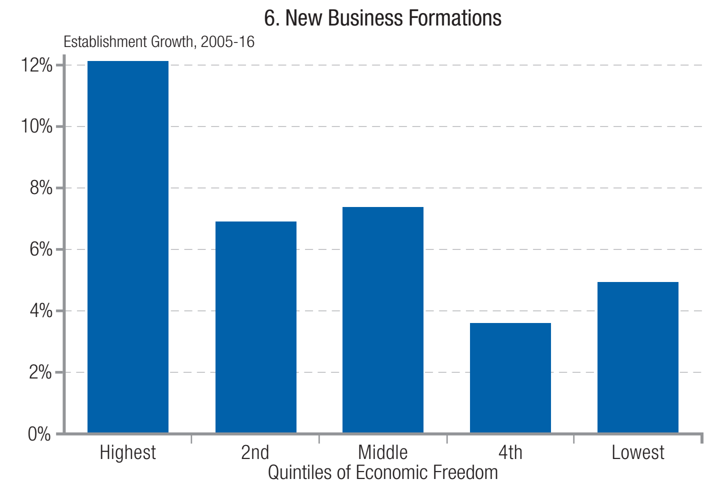
Calculating the cost of living allows us to compare the purchasing power of what workers get paid in each MSA. For the two groups with the most economic freedom, weighted average after-tax real earnings were approaching $40,000 in 2017 *(Chart 5)*. After that, earnings decline as economic freedom ebbs, settling below $29,000 in the least-free 20 percent. Median earnings also fall off as economic freedom declines.

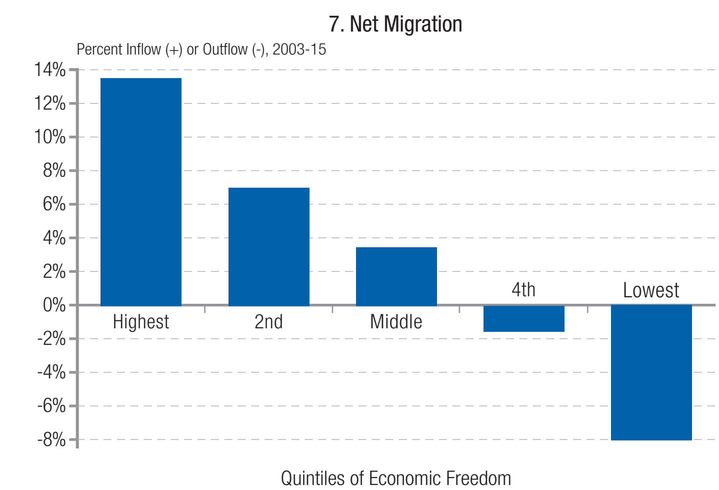
In dollar terms, paychecks are fat in many of the least-free MSAs—for example, New York, Los Angeles and San Francisco. But living costs and taxes are high, too, so workers in these MSAs can't afford to live as well as those with lower dollars-and-cents earnings in other places.

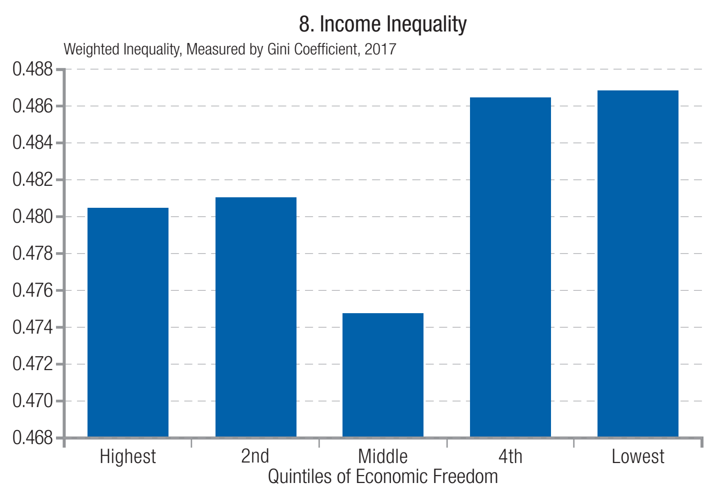
Economic freedom means greater opportunity for entrepreneurs who want to start their own companies. The number of business establishments in the most-free 20 percent of MSAs rose more than 12 percent from 2005 to 2016, *(Chart 6)*. Where economic freedom was low, new business formations lagged. Most likely, the results emerge from a combination of both fewer startups and lower survival rates.

People want to live where they find









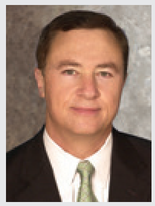
economic growth, job creation, higher living standards and opportunity. So it's not surprising to find Americans moved to the MSAs with high economic freedom and away from those with low economic freedom.

From 2003 to 2015, the most-free quintile of MSAs saw a net in-migration of almost 13.5 percent, while the group with the lowest economic freedom had a net out-migration of 8 percent *(Chart 7)*.

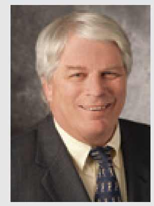
It might be assumed that successful urban economies' faster growth and dynamism would mainly benefit the rich at the expense of the poor. To test this idea, we calculated Gini coefficients for the Top 100 MSAs—lower values mean greater equality and higher ones more inequality.

The results for 2017 found the most equality in the middle of the economic freedom spectrum *(Chart 8)*. However, inequality was higher in the least free 40 percent than in the most-free 40 percent. More economic freedom might not solve the problem of inequality—but it doesn't seem to make it worse.

More than two decades ago, Adam Smith wrote about the *Wealth of Nations*. He lived in a pre-industrial world, where rural production dominated the economy. Today, the United States is overwhelmingly urban, and its economic well-being flows from the Wealth of Cities. Even after the great economic changes since Smith's time, we find that the ultimate secret to prosperity remains broadly the same—greater economic freedom.



Michael Cox
W. Michael Cox is founding director of the William J. O'Neil Center for Global Markets and Freedom at Southern Methodist University's Cox School of Business. A former Dallas Fed chief economist, he is economic advisor to MPACT Financial Group.



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

CHARTING THE ECONOMY

Fed's Tightening Pushes Up Short-Term Rates, Not Long-Term Ones

The Federal Reserve has gradually tightened monetary policy since 2016, nudging the federal funds rate upward. The Fed's actions were taken in the face of a strong economy that pushed inflation from near-zero in 2015 to above 2 percent in recent readings.

Short-term rates have risen in step with the fed funds rate—for example, one-month Treasuries went from nearly 0 percent in late 2015 to over 2 percent today (*see chart*). On the other end of the maturity spectrum, 30-year bonds have remained fairly stable, even dipping a bit in 2016.

The shrinking spread between short and long rates suggests the Fed's timely actions have helped keep a lid on inflation expectations. Otherwise, the longer rates would have risen with the short rates.

Longer-term rates are key to the economy. When they go higher, it drives the stock markets down, lowers wealth, discourages consumer spending and reduces business activity.