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Southwest Economy

Don't Mess with Texas

Texas' economic recovery has been a little underwhelming. For two years, the state's employment and output have grown more slowly than the rest of the country's. Lagging behind is somewhat unusual for Texas, which for a half century has run ahead of the nation in job growth for all but three periods.[1]

Texas pulled out of such sluggish periods in the past by letting economic forces play out. After restructuring, the state emerged stronger and better equipped to ride the next wave of expansion. There's no reason to think that won't happen again.

Domestic and global forces are now reshaping the Texas economy, and that process is restraining growth. Competitive pressures are spurring companies to reduce costs. Low interest rates and an investment tax incentive have encouraged companies to put money into productivity-enhancing technologies and equipment. At the same time, an increasingly global economy is helping producers cut costs by importing goods and services, freeing up resources that can be invested in other operations.

These changes will yield widespread benefits. Businesses and consumers will be able to purchase

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Social Security and Medicare: No Free Lunch

Public attention has recently focused on the federal budget outlook for the coming decade.[1] But as Alan Greenspan and other observers have noted, the real budget challenge is the long-run growth of Social Security and Medicare.

These programs are big and getting bigger, outpacing the growth of revenue. Large tax increases or benefit cuts will occur to address this shortfall, no matter how much we might wish they could be avoided.

In their current form, Social Security and Medicare involve transfer payments from the young to the elderly rather than actual saving. Scaling back these transfer payments would increase national saving and give future

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goods and services that might not otherwise be available or available only at higher prices. Resources no longer needed in one industry will be freed up for more profitable enterprises. Ultimately, restructuring will lead to economic growth, more jobs and higher living standards.

Such changes will mean painful adjustments for some companies and workers. But with the pain comes gain. Texas' history of adapting to economic change in part explains the state's favorable business climate and persistent strong growth. Efforts to manage reorganization would only create a drag on economic activity.

Economic Evolution in Texas

Free enterprise generates its power from a clash between new and old industries, a process economists call creative destruction.[2] Economies move forward as new competitors arise to offer new, better or cheaper goods and services. Old industries lose their markets because their products are now less desirable or more expensive. Real estate, labor, capital and other resources freed from shrinking industries are used to help build industries that offer new products and services consumers find more attractive. A flexible economy allows this process to occur, resulting in faster growth and higher living standards over the long run.[3]

Creative destruction has been important in shaping the Texas economy. In the 1970s, for example, the state prospered largely on its natural wealth, its resources focused on extracting and processing oil. By the early 1980s, a steep drop in oil prices and dwindling reserves had reduced the energy industry's profitability, and sluggish job and output growth resulted.[4] Oil and gas extraction companies suffered sizable job losses, which sent shock waves through other industries, particularly real estate. The state underperformed the rest of the country while workers and other resources lay idle—a drag on the economy, but also a lure for new business.

At the time, few could see the high-tech boom just ahead. But as the 1990s began, telecommunications and semiconductor companies located jobs and factories at a faster pace in the state than in the rest of the country. Texas provided fertile ground for the high-tech expansion, thanks to resources that were readily available—and cheap—as a result of the previous decade's punishing restructuring in the energy sector.

The economic revival in the 1990s occurred because Texas maintained a friendly business climate that relied on free enterprise to shape the future. The state largely rejected the use of intervention to stem job losses. Governments can undermine the business climate by trying to influence the allocation of resources to industries, subsidizing investment in certain activities, and protecting companies with subsidies and tax abatements.

It is painful to watch well-known companies shrink because they no longer produce a valued product at a competitive price. But efforts to protect failing industries ultimately raise the tax burden, increase the cost of living and restrain economic growth.

Since the high-tech boom went bust in 2001, the Texas economy has faced another bout of sluggishness. The state must now deal with both the damage in the tech sector and other economic forces pushing companies to restructure. Some of these factors arise from the domestic economy. Others are more global.

Domestic Forces for Change. The defining characteristic of Texas' recent economic performance has been the relatively slow pace of job creation. The explanation for that starts with what's happened since the nation slipped into recession in 2001.

The first downturn in a decade intensified the competition that drives creative destruction. To survive, companies looked for ways to introduce new products, lower costs and increase productivity. Many industries found the solution in technology. Low interest rates and a temporary change in federal tax law cut the cost of capital relative to labor, adding incentives to upgrade equipment and technology.[5]

Competition and cheap credit provide powerful inducements to invest in the latest technologies and adopt the organizational changes they make possible. For example, computers, software and scanners allow retailers to manage inventory more efficiently, help companies monitor their operations, and speed the delivery of information and products.

Innovations in computers, information management and communications have come rapidly over the past decade, allowing companies to make impressive increases in output without adding workers. The full costs of new production methods are often paid before the full benefits are received, so Texas' adjustment is still under way. Research suggests it can take years for the productivity produced by new technologies to fully emerge.

While the cost of capital fell, employers faced increased labor costs, mostly for benefits. Workers' compensation taxes are up for many businesses, but the largest increases have been for health insurance. Higher labor costs discourage hiring additional workers.

Economic uncertainty also slowed job creation. It is expensive to hire and fire workers, and companies prefer to make these decisions when they're more sure of the economic outlook. Over the past few years, business leaders have expressed concern about global terrorism, war and, in 2004, the presidential election's short-term impact on the economy.

Global Forces for Change. Trade has increased greatly over the past several decades as international agreements have opened markets and eliminated tariffs and other barriers. Recent gains in trade have intensified competition.

Without trade, however, Americans would be unable to purchase German beer or Japanese cars. Residents of Alaska would have lots of salmon to eat but none of the melons or chili peppers Texans enjoy. Texans would have fewer people purchasing their chemicals, plastics and computers, reducing employment in those sectors.

Trade allows more producers to specialize in what they do best. Some countries, like China, are efficient at making standardized products that are inexpensive to ship. Texas is shifting away from the production of these types of goods. The state's advantages lie in other endeavors, such as providing the energy industry with equipment and technical support, facilitating wholesale trade and developing innovations in electronic components.

It would be costly and inefficient for every country to maintain the skills and knowledge to make everything their citizens consume. By allowing each country to specialize, consumers can buy less expensive products. As a result, living standards rise directly by lowering import prices and indirectly by giving consumers more disposable income to spend on other goods and services.

Trade makes consumers better off, but how they spend their money determines winners and losers in the marketplace. Through billions of individual decisions, consumers cause the restructuring that roils economies and leaves them stronger.

Global competition forces existing companies to be innovative and efficient. Businesses can obtain inputs at a lower cost, import new technologies and expand production as they find new markets overseas. It allows the economy to shed less productive companies and industries, freeing resources to meet other consumer needs.

When it comes to business, the benefits of freer trade lie in new customers and new tools to compete. For economies, they lie in what protectionists decry—the increased competition that is at the heart of creative destruction. Trade not only destroys jobs, it creates them.

Trade makes consumers better off, but how they spend their money determines winners and losers in the marketplace.

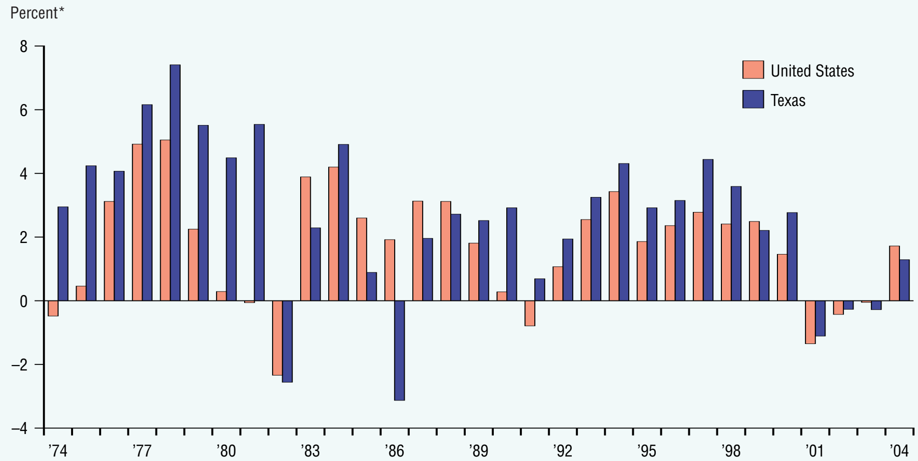
Texas Restructures in 2004

The forces of domestic and global competition have been reshaping the Texas economy. After emerging from recession in mid-2003, the state's recovery gained momentum in 2004, although activity was relatively weak overall. Some industries added jobs at a rapid clip, but restructuring—particularly in manufacturing and the airline industry—restrained total employment. Job growth was up 1.3 percent in 2004, well below the roughly 3 percent average of the past 30 years (*Chart 1*).

Creative destruction is apparent in a more detailed look at employment (*Chart 2*). Nearly all 2004 job growth was in the service sector, expanding its share of the economy. Jobs were added in finance, insurance, education and health care. All told, services gained more than 120,000 workers in 2004. With Texas' favorable business climate, com-

Chart 1

Texas 2004 Job Growth Dips Below 30-Year Average and Trails U.S. Performance



*Seasonally adjusted, annualized rate.

NOTE: Data are for nonfarm jobs only.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Legislation and other restrictions that limit competition between carriers raise the cost of living in Texas and slow long-term economic growth.

panies took advantage of increasing demand, often in markets with less foreign competition.

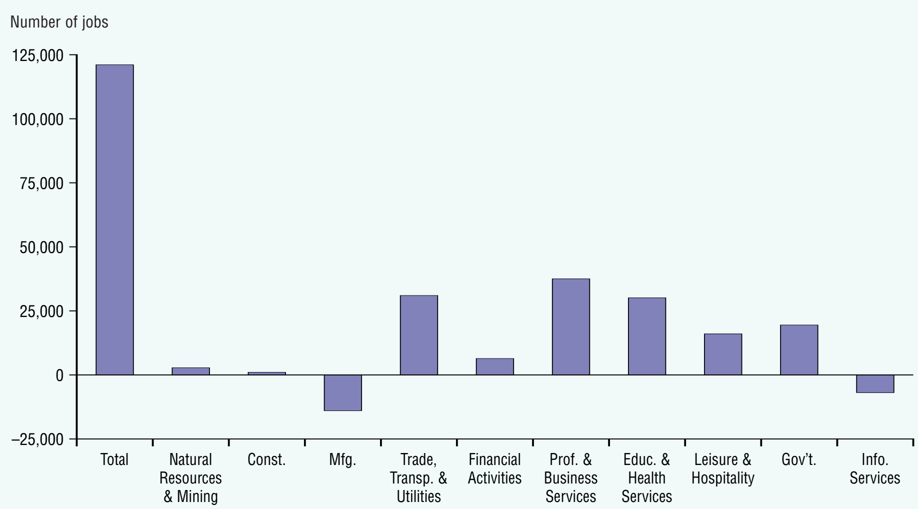
The state's railroad industry has done well over the past year, but the airline industry remains in the throes of a major restructuring.

U.S. airlines face increased pressure to reduce costs, stemming from Internet pricing competition, a drastic drop in demand following the September 11 attacks, new security regulations and higher fuel costs.

Air transportation employment has been falling since 2001, with 2,300 jobs cut in 2004 alone (*Chart 3*). In the past year, Continental, American and Delta airlines have announced layoffs and wage cuts in Texas. The only carrier that has been expanding is Dallas-based Southwest Airlines, which has a much lower cost structure than its competitors.

Chart 2

Service Sector Drives 2004 Texas Job Growth



SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 3

Texas Air Transportation Employment Continues to Fall

*Seasonally adjusted.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Globalization gets a lot of attention, but domestic factors have been the overwhelming driver of restructuring in manufacturing.

Industry cost-cutting is unlikely to let up in the foreseeable future. Legislation or other restrictions that limit competition between carriers will only raise the cost of living in Texas and slow long-term economic growth.

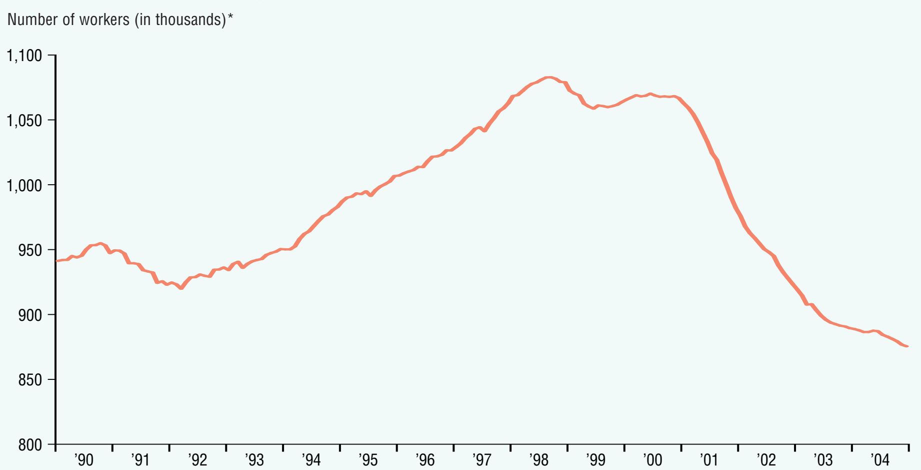
Like air transportation, Texas manufacturing is struggling with a major restructuring. In 2004, 14,000 jobs were lost, continuing a decline that started in the late 1990s (*Chart 4*). The shrinking of manufacturing relative to the service sector has been a long-run trend in this country. It is also a global trend experienced by most of our trading partners.

In Texas, the trend has affected all manufacturing industries. Some companies are investing in technology and making other changes to increase output using fewer workers. Others are losing out to foreign competitors, particularly in low-wage industries.

All Texas manufacturing industries reduced employment between 2000 and

Chart 4

Texas Manufacturing Employment Slides Dramatically



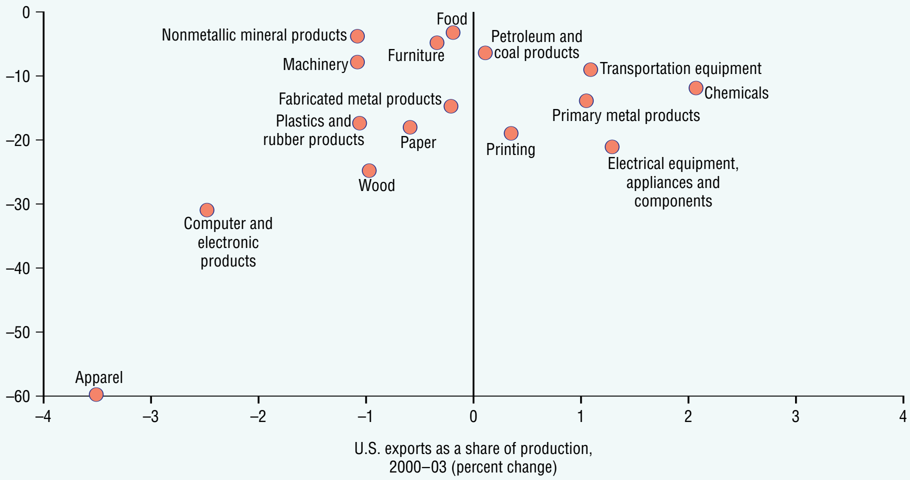
*Seasonally adjusted.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 5

Trade Saves Jobs

Texas manufacturing employment, 2000–03 (percent change)



NOTE: *X* axis measures exports divided by gross output.

SOURCES: Bureau of Labor Statistics; U.S. International Trade Commission; Federal Reserve Bank of Dallas.

2003, but some producers did better than others meeting the challenge from foreign trade.

Chart 5 shows whether there's a correlation between manufacturing job losses in Texas and exports.

Industries on the right side of the chart increased their share of U.S. production exported over the three-year period. Increasing their participation in global export markets reduced the need for these industries to cut jobs in Texas.

Industries on the left side of the chart exported a smaller share of domestic production, suggesting these U.S. producers may have lost some of their comparative advantage in the global market. The relationship between the change in the share of production exported and the change in employment is statistically significant and suggests that industries with the smaller job losses are those that have increased exports as a share of production over the three years.

Chart 6 looks at the change in the percentage of U.S. consumption imported from 2000 to 2003, by sector. For industries on the right side, an increasing proportion of U.S. consumption has come from imports, suggesting that domestic consumers are getting lower prices or greater variety through global trade.

Unlike exports, no statistically significant relationship exists between losses in Texas manufacturing jobs and increased foreign competition. Employment declines have been primarily driven by other factors, such as investment in productivity-enhancing technology.

Globalization gets a lot of attention, but domestic factors have been the overwhelming driver of restructuring in manufacturing.[6] It's incorrect to infer that globalization does not matter at all. Clearly, some industries, such as apparel, have been bleeding jobs as the result of stiff global competition. These competitive forces are expected to continue—and in some cases intensify—in 2005 and beyond.

Employment in Texas apparel manufacturing has fallen 60 percent since 2000. The United States is losing market share, and domestic production has fallen rapidly along with apparel prices, benefiting consumers. In 1994, the World Trade Organization voted to eliminate all textile and apparel quotas by January 2005. Textile prices and domestic production will probably continue to fall.

Companies faced some unusual stresses in 2000–03. Competition was intense and demand was subdued, with both the U.S. and Texas economies in recession at least part of the time. What's more, the value of the dollar was higher than it is today, encouraging domestic consumption of foreign goods. Changing economic conditions might produce very different results for Texas manufacturing in 2005 and beyond.

Outlook for 2005

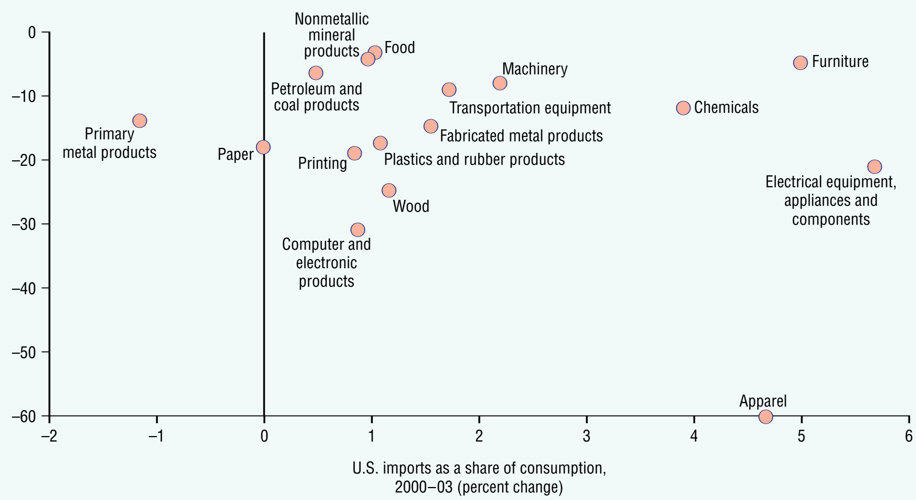
The restructuring of the Texas economy likely has further to go before its growth shifts into high gear.

The Texas recovery began modestly

Chart 6

Domestic Factors, Not Foreign Competition, Driving Texas Job Losses

Texas manufacturing employment, 2000–03 (percent change)



NOTE: *X* axis measures U.S. imports divided by the sum of gross output and imports.

SOURCES: Bureau of Labor Statistics; U.S. International Trade Commission; Federal Reserve Bank of Dallas.

Education and the Texas Economy

Education stimulates strong economic growth by boosting worker productivity and making the labor market more flexible. Today's workers are more likely than their parents to change employers and careers during their lifetime. Research shows that education smoothes the transition between careers and jobs.

The performance and funding of Texas' public education system have been under fire for decades.[1] Critics cite a dropout rate above the national average, as well as data showing that Texas trails the rest of the country in SAT scores and per pupil spending on K–12 education.

In early December, a state district judge issued a final order saying the maximum amount of funding available under the school finance formula is inadequate. He gave the Texas Legislature until October 2005 to fix what he ruled were constitutional deficiencies in the system. Lawmakers have pledged to raise taxes to fund increased spending for schools.

If the Legislature decides the solution is more money, the type of tax could affect long-run economic performance. A stable, broad-based tax structure, with the fewest distortions possible, would be best for the business climate. A neutral tax treats all business endeavors the same. Breaks or incentives given to one firm or individual must be paid for by others, introducing distortions into the economy. Distortions create an inefficient allocation of resources that slows overall growth.

Taxes work best when they're paid by those who will use the services they fund. So although income redistribution may be necessary in some instances, there are benefits to retaining as much local control as possible. If the local share of school funding falls, residents have less incentive to make sure their education dollars are used wisely. A 2000 study suggests that the larger the state share in educational finance, the less efficient the public schools.[2]

Higher spending won't necessarily improve educational quality. While more money can lead to educational improvements, better schools are also possible without increased funding—if other changes are made.

Public schools are largely untouched by the competition that drives innovation and efficiency in the private sector. Markets work best when consumers—in this case, parents—possess the information they need to make decisions. Reforms that bring transparency, disclosure, accountability and market forces to schools can be powerful stimulants to improved educational outcomes.

Bigger education budgets that don't improve school quality run the risk of slowing economic growth.

Notes

1 For more about the state's school finance system, see "Improving Public School Financing in Texas," by Lori Taylor, Jason Saving and Fiona Sigalla, Federal Reserve Bank of Dallas *Southwest Economy*, November/December 2001.

2 "Evidence on the Impact of State Government on Primary and Secondary Education and the Equity–Efficiency Trade-Off," by Thomas A. Husted and Lawrence W. Kenny, *Journal of Law & Economics*, vol. 43, April 2000, pp. 285–308.

accelerating toward the end of 2004, partly the result of energy producers responding to high prices. The state's economy should continue to slowly accelerate in 2005, growing at a pace roughly the same as the nation's or slightly faster.

The strengthening energy industry may help the state catch up to the national growth rate, but it probably won't drive the expansion forward at a rapid clip. Headwinds from restructuring will keep Texas job growth below its long-run trend. Pending issues—notably, education financing—are creating uncertainty and may change the business climate. (See the box on this page.)

Over the past 30 years, Texas has surpassed the nation in employment growth by an average of slightly over 1 percent a year. Whether the state regains its historical edge depends on what emerges from the current restructuring. What will the next fast-growing industry be? When will it arrive? No one can answer these questions with certainty.

While it is difficult to know what's next, Texas has done well in the past by improving an already good business climate and allowing economic forces to play out.

When the economy hits a rough patch, there's a temptation to tinker. But Texas stands a better chance of regaining its economic vigor by sticking with a strategy that works. The slogan of the state's antilitter campaign might apply: Don't mess with Texas.

—Fiona Sigalla

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Notes

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1 Over the past 50 years, Texas employment was weaker than U.S. employment in 11 years: 1959–60, 1962, 1983, 1985–88, 1999, 2003 and 2004.

2 In 1942, Joseph Schumpeter coined the term *creative destruction* in his book *Capitalism, Socialism, and Democracy* to denote a process of industrial mutation that incessantly revolutionizes the economic structure from within, continuously destroying the old one while creating a new one.

3 The Dallas Fed has discussed the importance of free trade, creative destruction and productivity in a number of annual report essays. Among them are "A Better Way: Productivity and Reorganization in the American Economy" (2003 Annual Report), "The Fruits of Free Trade" (2002) and "The Churn: The Paradox of Progress" (1992). The essays, written by W. Michael Cox and Richard Alm, can be found at www.dallasfed.org.

4 The causes of the energy bust were more complicated than this. For a more detailed explanation of what led to overinvestment in the energy and construction industries, see "The Energy Industry: Past, Present and Future," by Stephen P. A. Brown and Mine K. Yücel, Federal Reserve Bank of Dallas *Southwest Economy*, July/August 1995, and "The Texas Construction Sector: The Tail That Wagged the Dog," by D'Ann M. Petersen, Keith R. Phillips and Mine K. Yücel, Federal Reserve Bank of Dallas *Economic Review*, Second Quarter 1994.

5 Between Sept. 11, 2001, and Dec. 31, 2004, the federal government gave companies a "bonus depreciation" that allowed them to immediately deduct (rather than depreciate over time) a part of the cost of equipment and software investment.

6 There is a statistically significant relationship between U.S. manufacturing employment and the change in the share of production exported. There is no statistically significant relationship between losses in U.S. manufacturing jobs and increased foreign competition. These findings show the strength of the Texas results.