



FIRST QUARTER 2012

Southwest Economy

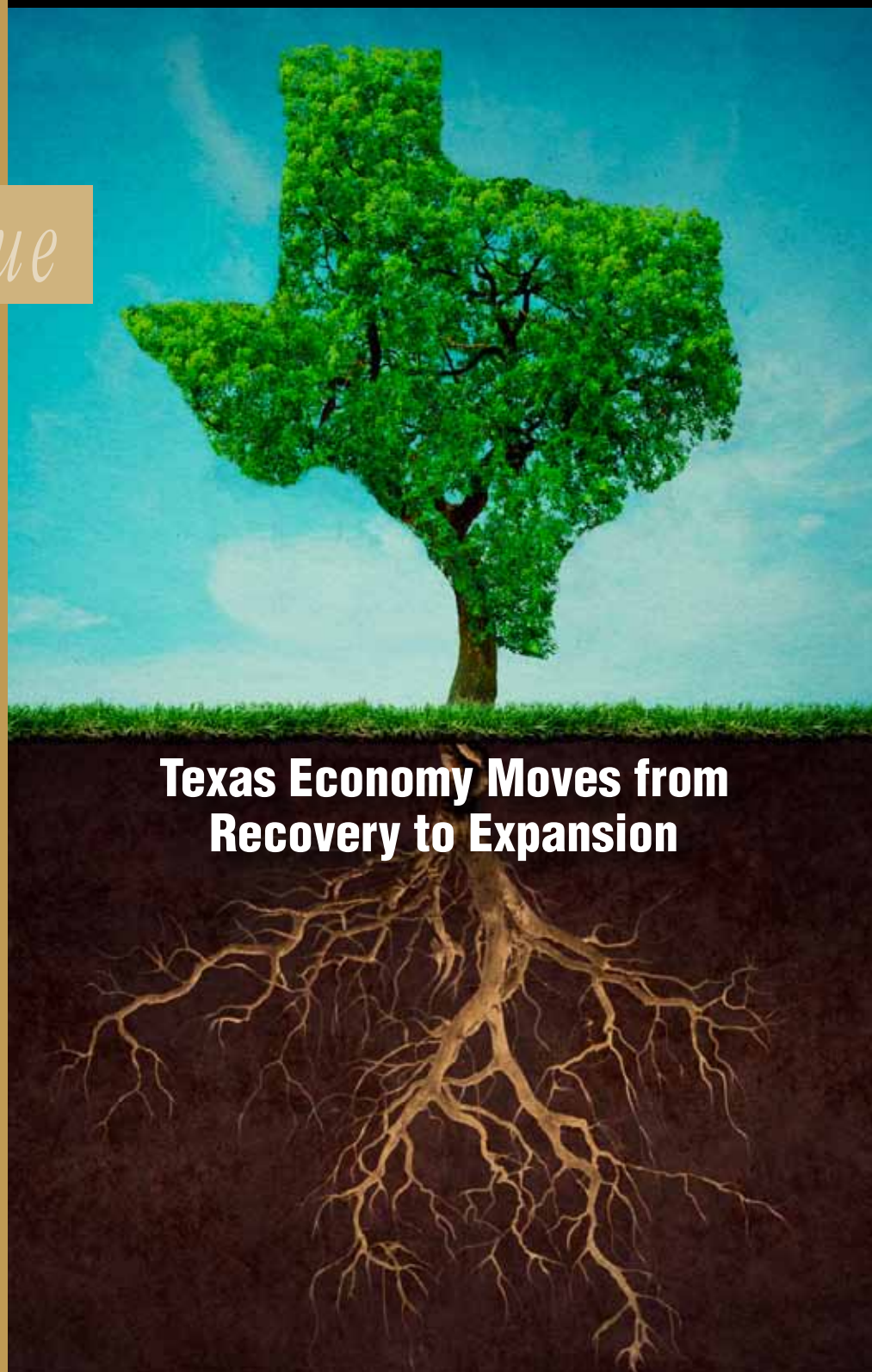
FEDERAL RESERVE BANK OF DALLAS

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**Texas Economy Moves from
Recovery to Expansion**

President's Perspective



Our fiscal authorities must not only figure out a way to contain the nation's runaway deficits and bulging debt, but also overhaul our current tax, spending and regulatory regime in a way that induces businesses to invest here.

As we enter an election year, much of the focus will be on creating jobs for American workers. And rightfully so. Far too many remain unemployed and underemployed.

To ensure long-term, sustainable job growth, we need to pay heed as a nation to the more encompassing goal of ensuring U.S. economic competitiveness. In a world driven by rapid technological change and globalization, job-creating capital flows readily to the most welcoming, competitive economies.

This was underscored in a recent Harvard Business School survey authored by Jan Rivkin and Michael Porter, one of the world's leading authorities on national competitiveness and economic development. The results were startling. The survey of school alumni found that more than 70 percent of respondents expect U.S. competitiveness to decline over the next three years. The greatest impediments to investing and creating jobs in the United States, the survey found, are the U.S. tax code, workforce skills, regulatory burdens and uncertainty. When asked to suggest how government officials can improve competitiveness, some 30 percent cited tax-related issues.

While not the purview of the Federal Reserve, tax, regulatory and education policy all have significant implications for our long-term well-being. The Federal Reserve has done much to put our country back on the path to economic expansion, but it cannot do the job alone. Our fiscal authorities must not only figure out a way to contain the nation's runaway deficits and bulging debt, but also overhaul our current tax, spending and regulatory regime in a way that induces businesses to invest here. Only then will jobs be created for Americans in an increasingly competitive and interdependent global economy.

Rebooting an entire system of economic incentives is a daunting task. Fortunately, as American Enterprise Institute resident scholar and former Dallas Fed economist Alan Viard demonstrates in his "On the Record" interview in this issue of *Southwest Economy*, there are many good ideas on how to contain our deficits and revamp our outdated tax system. The sooner our fiscal authorities get to it, the better. Our nation's future depends on it.

A stylized, handwritten signature in gold ink that reads "Richard W. Fisher".

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas



Texas Economy Moves from Recovery to Expansion

By Keith R. Phillips and Jesus Cañas

Leading economic indicators have increased in recent months, suggesting growing momentum going into 2012.

The Texas economy, which moved from recovery to expansion in 2011, appears poised for another year of moderate growth. Employment in December edged 0.1 percent above its prerecession peak, reached in August 2008. The nation, meanwhile, remains 4.4 percent below its high point.

If the U.S. follows its average annualized employment growth rate since 1980 (1.2 percent), the country will need about 46 months—or close to four years—to match the state's accomplishment.

Last year, the Texas economy grew at about the same pace as in 2010. Employment increased by about 2 percent—212,000 jobs—compared with 1.3 percent nationally. Led by a boom in the energy sector and strong growth in exports, particularly in petrochemicals and high tech, Texas private sector employment growth accelerated to 3.3 percent in 2011

from 2.5 percent the year before. A sharp 3.3 percent decline (53,700 jobs) in state and local government jobs offset private sector expansion.

Leading economic indicators have increased in recent months, suggesting growing momentum going into 2012. Housing continues to mend and construction activity may improve slightly. Additionally, steep cuts to state and local government spending over the past 12 months probably won't be repeated. Conversely, weaker growth in exports and a slowdown in the rapid expansion of oil and gas extraction curb 2012 expectations, leading to anticipated overall job growth of close to 2 percent again this year.

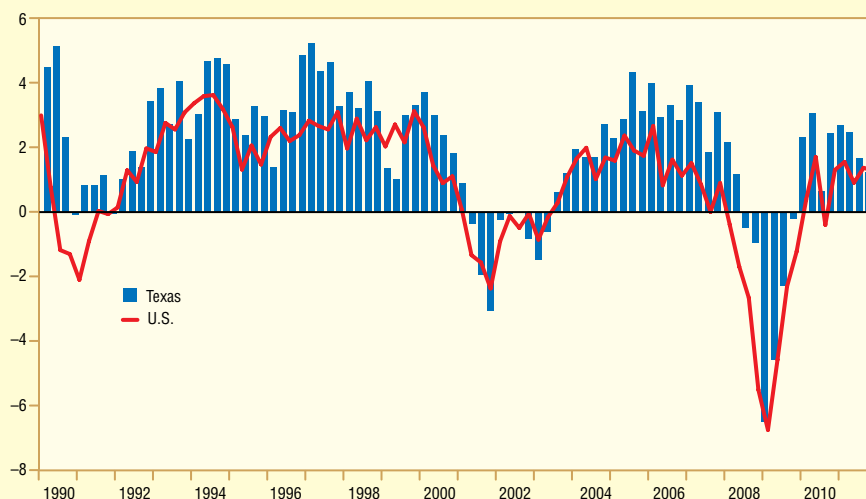
2011 Ends Sluggishly

Employment expansion started 2011 strongly and slowed as the year progressed (*Chart 1*). Texas outperformed the U.S.

Chart 1

Texas Job Growth Slows in Second Half of 2011

Percent quarter over quarter*



* Seasonally adjusted, annualized rate.

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

during the first three quarters but fell to the national rate during the fourth quarter. Growth sectors in order of strength were oil and gas, professional and business services, leisure and hospitality, manufacturing, educational and health services, trade and transportation, and financial activities. Government, information and construction closed 2011 with employment losses, with the largest declines in state and local government jobs (*Chart 2*). Since peaking in June 2010, Texas state and local government employment has dropped 4 percent, most of it occurring near the start of the 2011–12 school year. Nationally, state and local government jobs fell 3.3 percent from a peak in August 2008.

Oil Prices and Technology

A source of Texas economic strength, oil and gas extraction recorded a 25 percent increase in the number of drilling rigs in 2011, almost reaching its mid-2008 peak (*Chart 3*). Strong oil prices and new technology—the use of hydraulic fracturing to reach deep pockets of energy resources not previously attainable—propelled the gain, which produced a 15 percent rise in mining employment last year. The Eagle Ford shale region, a 24-county area in South Texas extending eastward from Webb County (county seat: Laredo) on the Texas–Mexico border to Brazos County (county seat: Bryan), is one area benefitting from hydraulic

fracturing. Area oil production increased to 21.8 million barrels in 2011 (through November) from 4.4 million barrels in 2010, and gas production rose to 221 billion cubic feet in 2011 from 108 billion cubic feet in 2010, according to the Texas Railroad Commission. Employment and wages in the mostly rural Eagle Ford counties have grown sharply in the past few years.

Exports are an important driver of the economy. Texas ranked ninth among the

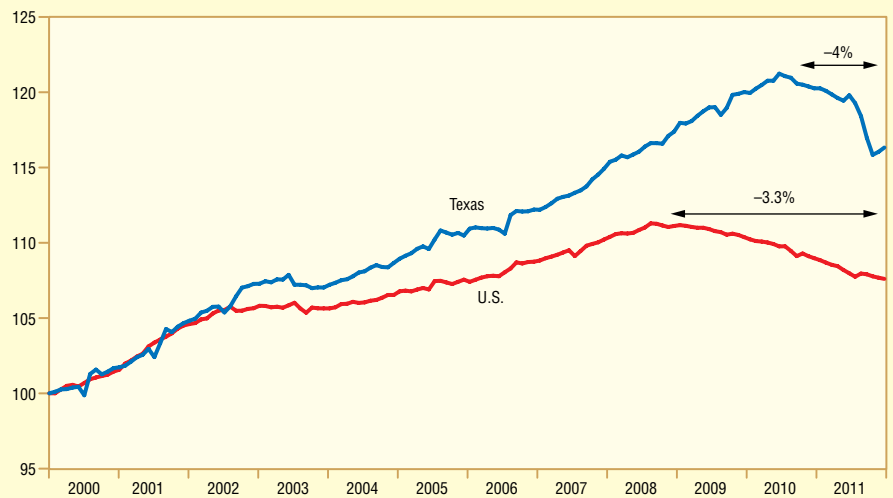
states in the percentage of civilian jobs tied to exports (8.2 percent) in 2008, according to the Census Bureau. Since hitting a trough in early 2009, Texas exports have grown at a faster pace than in the rest of the U.S.—surpassing the previous monthly, inflation-adjusted peak of \$16.2 billion by about 11 percent last year (*Chart 4*). State exports increased at a 12.3 percent annual rate from December 2010 through April 2011, declining through July and bouncing back in the following three months. The value of exports in October nearly equaled April's total.

Texas felt the impact of distant world events. Economic growth began the year strongly in the U.S. and internationally, but the earthquake and tsunami in Japan in March slowed global manufacturing as industries struggled with parts shortages. Although the shortages eased in the second half, the euro-zone debt crisis and resulting slowing economic expansion suppressed Texas' export recovery. Additionally, the euro-zone crisis increased the value of the U.S. dollar—the result of a financial flight to quality that sought the dollar's relative safety. U.S. goods sold abroad became more expensive because of the stronger currency. The increase in the Texas value of the dollar, an aggregate exchange-rate measure that weights real exchange rates based on the shares of Texas exports, is depicted in *Chart 4*.¹

The summer export slowdown likely damped manufacturing activity in the sec-

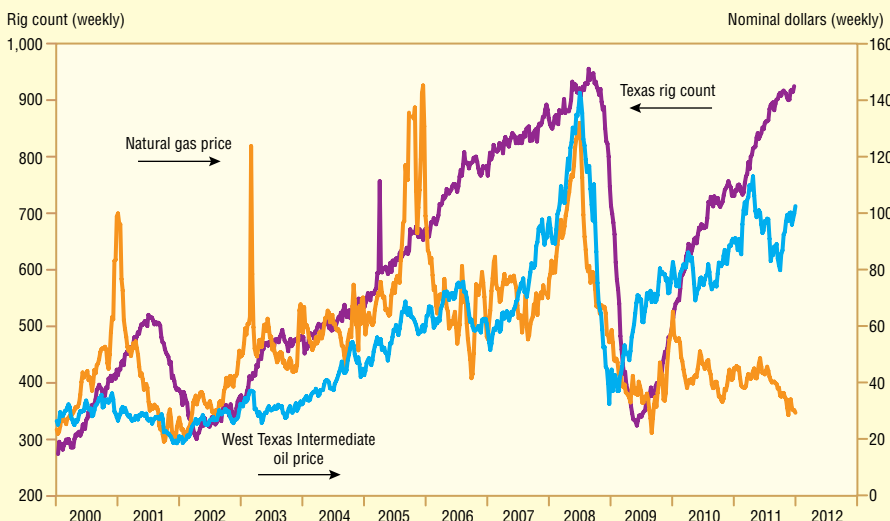
Chart 2
Texas State and Local Government Jobs Decline Sharply in 2011

Index, January 2000 = 100



SOURCE: Bureau of Labor Statistics.

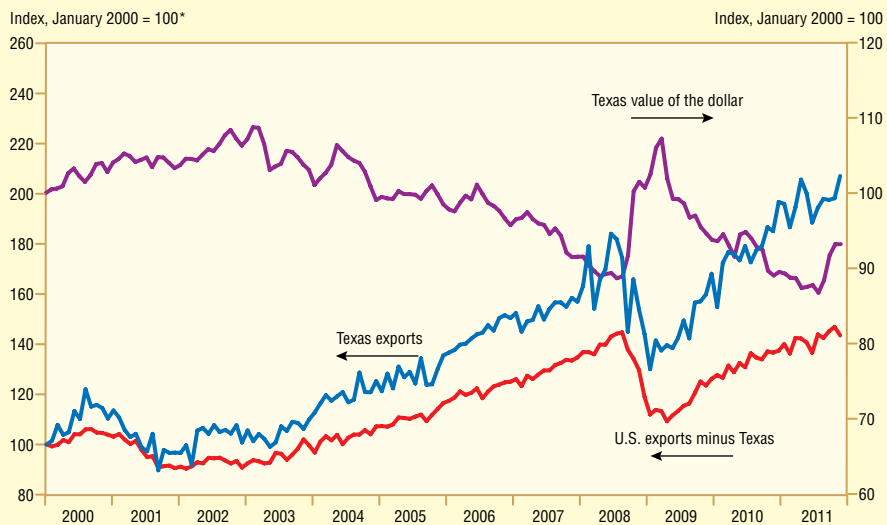
Chart 3
Rig Count Increases to Prerecession Levels



NOTE: Gas price is multiplied by 10.

SOURCES: Wall Street Journal; Baker Hughes; Haver Analytics.

Chart 4
Texas Exports Outpace Rest of U.S.



SOURCES: Census Bureau; Bureau of Labor Statistics; Federal Reserve Bank of Dallas; authors' calculations.

ond half of 2011, as reflected in the Dallas Fed's Texas Manufacturing Outlook Survey. The survey's index of new orders posted negative readings in November and December 2011 before rebounding in January. Slowing total nonfarm and private sector job growth in fourth quarter 2011 reflected the year's second-half export lull and the sharp decline in government jobs.

workers in manufacturing), help-wanted advertising and initial claims for unemployment insurance also contributed to the index's rise.

Generally, hours worked pick up before job gains because employers respond to increased demand by using current employees for more hours, waiting to add new personnel until they are sure demand

will be sustained. Increasing online and print advertising for job openings reflects employers' desire to hire in coming months. And finally, declining initial claims for unemployment insurance are a sign that fewer workers are being laid off.

The only negative TLI indicators were well permits and the Texas value of the dollar, which increased toward the end of the year, reflecting more expensive state exports, which tend to suppress manufacturing sector growth. The well permits decline indicates a slowing of the rapid expansion of oil and gas extraction at the end of 2011.

A forecasting model based on the recent momentum in job growth and the TLI suggests that employment expansion will gradually pick up from the weak pace in the fourth quarter to reach the 2 percent projection, the third consecutive year of that rate.

Housing and Government Improving

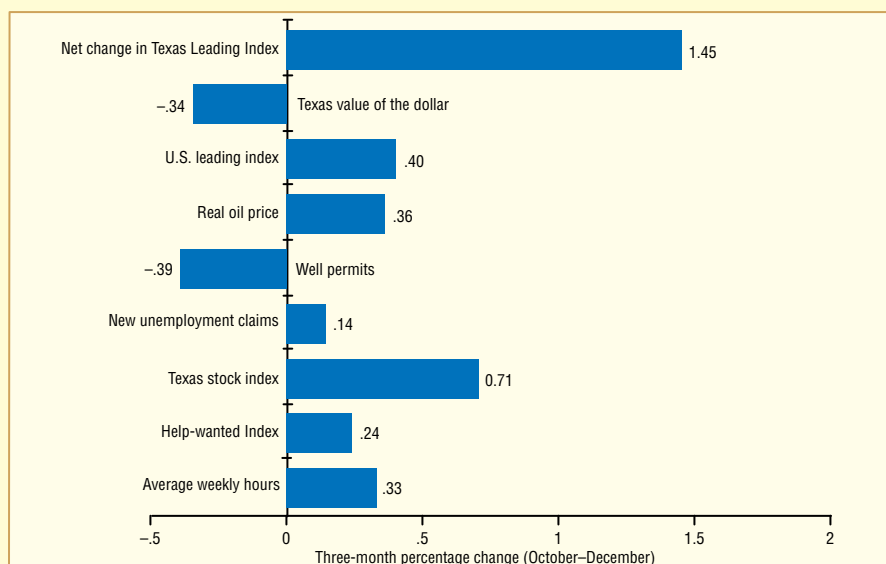
While job growth will be little changed this year, underlying economic strengths and weaknesses will likely differ. The World Bank forecast in January that real global GDP growth would slow slightly to 2.5 percent this year from 2.7 percent in 2011. Weaker expansion, particularly in Europe, could soften Texas exports. And Texas' largest export customer, Mexico, anticipates growth slowing to 3.2 percent from 3.9 percent in 2011, according to Mexico's Central

2012: Momentum Picking Up

Despite the July-to-December slowdown, leading economic indicators increased as the year closed. The gains suggested that the economy should improve in the first half of 2012. Changes in many of the key economic indicators that led movements in the broader economy are aggregated into the Texas Leading Index (TLI) (Chart 5). It is composed of indicators that tend to turn up prior to recoveries and down before recessions. In the three months ended in December 2011, six of the eight components of the TLI increased, resulting in an index increase.

Gains in the Texas stock index and in the U.S. leading index paced the advance. The increase in stock prices of Texas-based companies is a reflection of earnings growth and a positive outlook for businesses. The increase in the U.S. leading index suggests that the recovery in the national economy will continue in the short run, a positive sign for Texas growth. Real oil price, average weekly hours (of production

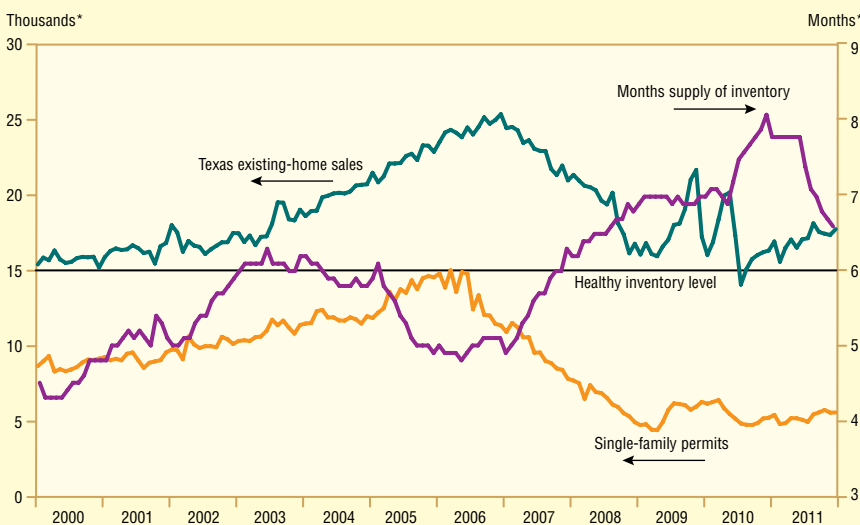
Chart 5
Most Texas Leading Index Components Are Increasing



SOURCE: Federal Reserve Bank of Dallas.

Taken together, the data on construction seem to suggest that Texas will experience gradual improvement in residential and nonresidential building activity in 2012.

Chart 6
Texas Existing-Home Sales Tick Up as Inventories Fall



* Seasonally adjusted.

SOURCES: Census Bureau; Multiple Listing Service; Federal Reserve Bank of Dallas.

Bank Survey of Economic Forecasters.²

The energy sector is expected to continue expanding, but its growth is unlikely to match 2011 levels. Oil prices were high at year-end, while natural gas dropped to relatively low levels (*see Chart 3*). A decline in natural gas drilling is anticipated because of depressed gas prices. Energy prices are difficult to predict, but if they remain stable near current values, the relatively high price for oil and the continued interest in hydraulic fracturing may result in a flat to slightly increased rig count that's unlikely to match the 25 percent rise in oil and gas drilling and the 15 percent employment gain recorded during 2011.

Meanwhile, the homebuilding and government jobs sectors are showing strength. Existing-home sales rose in November and are up 9.4 percent from a year ago in Texas. Anecdotal reports confirm stabilization of new-home sales, with modest growth in December. Prices remain down 3 percent from their peak in first quarter 2009, though existing-home inventories were at 6.6 months of supply in December, down from a peak of 8.1 months in December 2010 (*Chart 6*). Historically, six months of supply is seen as healthy, although with elevated rates of mortgage foreclosures and delinquencies of 90 days or more, current inventories may not represent as much market tightness as in previous periods because continued foreclosures could add to inventory levels.

The construction sector and single-

family building in particular typically grow briskly in the early stages of recovery. But after two years of the economic rebound, single-family housing has yet to strongly bounce back. Although contract values and the number of single-family permits (which precede construction of new houses) have risen slightly in recent months, only multi-family permits (for apartment complex construction) have increased significantly.

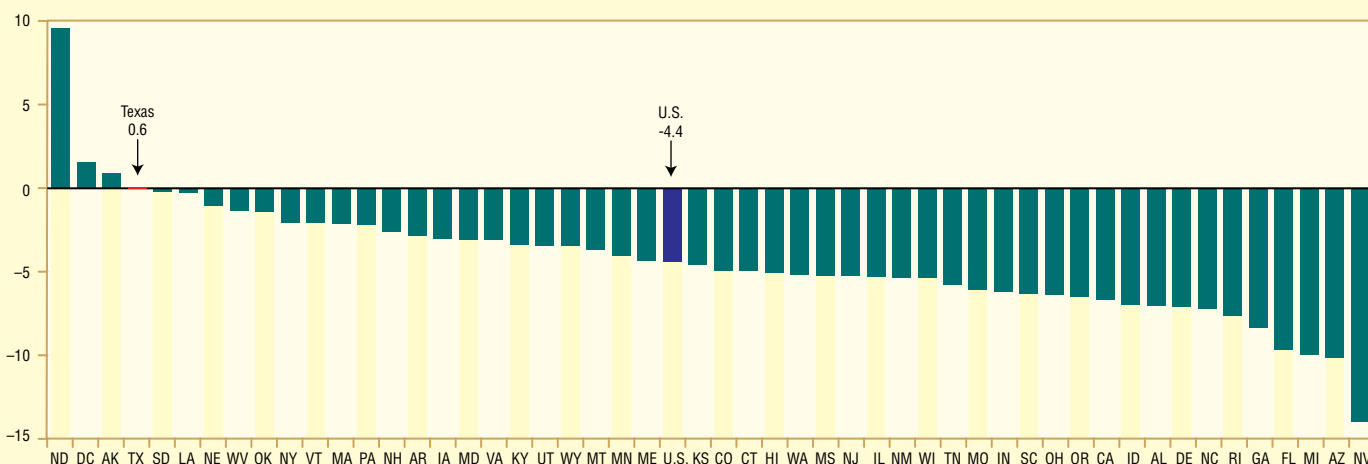
There are many reasons why people may favor renting over buying. Elevated foreclosure rates have reduced the credit scores of many individuals and, at the same time, resulted in increased credit standards among lenders. The sharp declines in home prices over the past several years may make many individuals question if prices have hit bottom. While only about 10 percent of mortgages in Texas are underwater—with more owed than the value of the property—as of third quarter 2011, many potential homebuyers may fear getting trapped in their homes without the flexibility to move if their economic situation changes. The Texas figures compare with 22 percent of mortgages underwater nationally and a high of 58 percent in Nevada.

However, in recent months there have been signs that most real estate markets are recovering. Vacancy rates in industrial, office and apartment markets all fell in the third quarter, and Texas existing-home sales generally have risen in recent months. Signs of bottoming out in the single-family housing

Chart 7

Texas Is One of Few States Moving from Recovery to Expansion

December 2011 jobs as percentage change from previous peak in jobs



SOURCE: Bureau of Labor Statistics; authors' calculations.

sector, along with decreases in the mortgage delinquency and foreclosure rates in the third quarter, indicate less bad news ahead. Taken together, the data on construction seem to suggest that Texas will experience gradual improvement in residential and non-residential building activity in 2012.³

State and local government is a major employment sector, accounting for about 15 percent of all jobs in the state. Thus, what happens in this sector will affect overall job growth this year. Texas state government bases much of its budget on retail tax collections, representing about 60 percent of revenue. Sales and use tax revenue grew strongly in 2011, resulting in a state comptroller's announcement that Texas' finances are in better shape than previously anticipated, with \$1.6 billion more in tax revenue than projected early last year. This increase, along with an expected slight rise in home values and continued strong levels of energy exploration in 2012, suggests that additional state and local government job cuts may not occur in 2012. Even if a reduction is undertaken, it would probably be much smaller than in 2011. In December 2011, government employment grew for a second consecutive month, a possible sign that state and local government employment has bottomed.

Texas: A National Leader

Even with a moderate rate of growth in 2011, Texas has moved into expansion

mode. Texas ranks fourth nationally in terms of jobs recovered relative to those lost during the recession (*Chart 7*). Only North Dakota, Alaska and Washington, D.C., have done better, according to data comparing the change from peak employment levels.

The Texas economy should continue growing at about the same rate as last year, although the factors affecting the expansion may change. Slower growth in exports and energy likely will be offset by a gradual improvement in construction and fewer cuts in state and local government jobs. Many factors could speed or slow activity. For example, as of early 2012, most analysts expected a mild euro-zone downturn. If it becomes more pronounced, Texas growth will be slower than anticipated; conversely, better-than-expected activity abroad would aid the state's prospects. Oil prices are another variable—a sharp decline could narrow Texas growth to less than the 2 percent forecast, while a rise would increase that projection only slightly.

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Notes

The authors thank Linda Bi for her research assistance and Mine Yücel and Pia Orrenius for helpful comments and suggestions.

¹ For more information on the Texas real trade-weighted value of

the dollar and other similar measures for other states, see "New Tool Gauges Impact of Exchange Rates on States," by Keith R. Phillips, Steve Brzezinski and Barbara Davalos, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2010, www.dallasfed.org/research/swe/2010/swe1004b.pdf.

² For more information on Mexico's Central Bank Survey of Economic Forecasters, see www.banxico.org.mx/informacion-para-la-prensa/comunicados/resultados-de-encuestas/expectativas-de-los-especialistas/index.html.

³ For a more-detailed look at the Texas and U.S. housing markets, see "Texas Housing on Bumpy Road After Stimulus Effects Fade," by D'Ann Petersen and Adam Swadley, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter, 2011, www.dallasfed.org/research/swe/2011/swe1102b.pdf, and "When Will the U.S. Housing Market Stabilize?" by John V. Duca, David Luttrell and Anthony Murphy, Federal Reserve Bank of Dallas *Economic Letter*, vol. 6, no. 8, 2011, www.dallasfed.org/research/eclett/2011/el1108.pdf.

Benefits of a Progressive Consumption Tax

Alan D. Viard, a resident scholar at the American Enterprise Institute, reviews the budget outlook, the need for tax reform and the benefits of moving to a progressive consumption tax. He also discusses his forthcoming book, *Progressive Consumption Taxation: The X Tax Revisited*, which he coauthored with Robert Carroll of Ernst & Young. The book will be published by AEI Press in the spring.

Q. What is the long-term budget outlook?

A. If current tax and budget policies are maintained, spending on Medicare, Medicaid and other health programs and, to a lesser extent, Social Security will grow much more rapidly than federal revenue during the upcoming decades. The Congressional Budget Office (CBO) laid out the grim arithmetic in its June 2011 analysis of the long-term budget outlook.

In its “alternative fiscal scenario,” which reflects a continuation of current policies, CBO projects that spending on federal health programs will soar from 5.6 percent of GDP in 2011 to 10.4 percent in 2035. The increase will be driven by rising health care costs, reinforced by the aging of the population and health care reform provisions that expand Medicaid and offer new subsidies for private health insurance. CBO also projects that Social Security spending will rise from 4.8 percent to 6.1 percent of GDP over this period, due to population aging. Total federal spending will persistently exceed revenue, which CBO assumes will hold steady at 18.4 percent of GDP, its average in recent decades. The resulting deficits will steadily add to the government’s debt. The federal debt, which has typically been below 40 percent of annual GDP and has reached 69 percent due to the recent recession, will rise to 187 percent of annual GDP in 2035.

Q. How are Congress and the president likely to ward off the projected shortfalls? What is the role of tax reform in addressing these fiscal imbalances?

A. Due to the political obstacles that either party would face acting alone, the fiscal im-



balance is most likely to be addressed in a series of bipartisan agreements. These will include both tax increases and cuts to entitlement spending, particularly Social Security and Medicare benefits. Federal tax revenue will rise above its 18.4 percent average share of GDP. Although entitlement spending will increase as a share of GDP, it will grow more slowly than CBO current-policy projections. A key part of the entitlement cuts will involve requiring recipients of Medicare and the other health programs to pay a larger share of their own health care costs; schemes to reduce the overall level of health care costs are unlikely to yield big results.

Although the richest 2 or 3 percent of the population, those with incomes above \$250,000 or so, have a large share of the nation’s income, it will not be possible to close the fiscal gap solely by raising their

taxes. People at more modest income levels, including the broadly defined middle class, will end up bearing part of the tax increases and nearly all of the entitlement cuts.

As federal revenue becomes a larger share of GDP, there will be pressure to reform the tax system to make it less economically inefficient. Because consumption taxation is less inefficient than income taxation, the federal tax system is likely to move toward consumption taxation, in some form and to some extent, over the upcoming decades.

Income taxes are more inefficient than consumption taxes because they penalize saving and investment. Under an income tax, a worker who spends his wages immediately is taxed only once—he pays tax on his wages. But, the income tax metes out harsher treatment to a worker who saves her wages and then spends her savings and interest at a future date. This worker pays tax on her wages and also pays tax on the interest she earns on her savings. As a result, she gets hit with a bigger percentage tax burden than the worker who spends his wages up front. In contrast, a consumption tax puts the same percentage burden on both workers, provided that the tax rate stays the same. Although consumption and income taxes both penalize work, the income tax is more inefficient because it also penalizes saving.

Q. What are the different ways that our tax system could move toward consumption taxation?

A. The most likely, although not the most desirable, would be to adopt a value-added tax (VAT) alongside the individual and corporate income taxes. The VAT is essentially the same as a retail sales tax but is collected in installments at each stage of business production. Many countries, including most of the European democracies, have VATs alongside income taxes.

It would be better to completely replace the income tax system with a consumption tax, which would fully eliminate the income tax’s penalty on saving and investment. That approach would also avoid the temptation for increased federal spending that might

“Switching from the income tax to the X tax is likely to boost saving and investment, which are key factors driving long-run growth.”



arise if the government had access to both an income tax and a consumption tax. But, it's hard to imagine that the income tax system should, or ever would, be completely replaced by a VAT or a sales tax. The problem is that VATs and sales taxes are regressive, meaning that they impose heavier tax burdens on people who are less well off.

The best approach is the complete replacement of the income tax by a progressive consumption tax, one that imposes heavier tax burdens on people who are better off. There's nothing impossible or self-contradictory about a progressive consumption tax, although it requires the use of an unfamiliar tax system. One type of progressive consumption tax is the personal expenditures tax (PET). Under the PET, households would file annual tax returns on which they would compute their consumer spending by subtracting their net saving from their income. Households would be taxed on their spending, with higher tax brackets applying to those with higher spending.

Although the PET has some advantages, I view the “Bradford X tax” as the best way to implement progressive consumption taxation.

Q. What is the X tax and how is it different from the current tax system?

A. The Bradford X tax was proposed by David Bradford of Princeton University in 1986. It is a modification of the “flat tax” proposed by Robert Hall of Stanford University and Alvin Rabushka of the Hoover Institution in 1983. The tax has two components, a household tax on wages and a business-firm tax on business cash flow.

Households are taxed only on their wages, not on any income from saving, such as interest, dividends or capital gains. Higher tax brackets apply to workers with higher wages. Workers with the lowest wages pay no tax and may receive cash from tax credits. If desired, it would be possible to allow some deductions on tax returns, such as charitable contributions, medical expenses, and state and local taxes.

Businesses, regardless of whether they are corporations, partnerships or sole proprietorships, are taxed on their business cash

flow at a high flat rate equal to the tax rate paid by the highest-wage workers. Firms are allowed to immediately deduct all business expenditures, including purchases of equipment and buildings, rather than depreciating them over a period of years. Firms do not deduct interest expense or any other financial outlays.

Although the X tax may look like an income tax, its economic properties make it a consumption tax. The wages on which workers are taxed plus the business cash flow on which firms are taxed add up to consumption. Two key features of the X tax guarantee that it imposes no saving and investment disincentives. First, households are not taxed on income from saving. Second, firms immediately deduct their investment costs, which cancels out, on the margin, the tax later imposed on the proceeds of those investments.

The X tax is progressive because it imposes the highest tax rates on high-paid workers and on people who consume from business cash flow while imposing lower tax rates on lower-paid workers.

Q. What are the advantages of the X tax?

A. Switching from the income tax to the X tax is likely to boost saving and investment, which are key factors driving long-run growth. Based on economic simulations, a reasonable middle-ground estimate is that the switch may boost long-run output by about 5 percent. The increased output will show up only gradually; in the short run, living standards will decline as households cut back on consumer spending and increase saving.

The X tax is also simpler than today's individual and corporate income taxes. Under the X tax, households report only their wages on their tax returns. Wages are generally the easiest type of income to report, as the necessary information can be taken

directly from the W-2 form. Business firms can immediately deduct all of their business costs, so they can avoid the complexities of depreciation, amortization and inventory accounting.

Q. Are there any disadvantages to the X tax that critics might seize upon?

A. As Bob Carroll and I discuss in our book, the X tax faces some challenges with respect to the taxation of business firms, international transactions and financial institutions. We outline ways in which these challenges can be addressed. We also discuss transitional issues and the tax treatment of housing, pensions and fringe benefits, and other special topics.

The biggest problems, though, may relate to popular perceptions of the X tax. The fact that the household component of the X tax applies to workers' wages, but not to investors' interest, dividends and capital gains, may pose political problems. Also, because the X tax looks like an income tax, it may be difficult to explain to Congress and to the public that it is a consumption tax.

Limited English Skills, Relative Youth Contribute to Hispanic Poverty Rates

By Yingda Bi, Pia Orrenius and Madeline Zavodny

The Hispanic population's well-being plays an increasingly important role in regional and national economic prosperity. Hispanic workers' skills and education will help determine the future productivity of the labor force and competitiveness of U.S. industry.

Hispanic poverty rates are high compared with other major demographic groups and have improved little in the past four decades. In 2010, 26.4 percent of Texas Hispanics fell below the poverty line versus 9.2 percent of non-Hispanic whites (*Chart 1A*); nationally, 24.6 percent of Hispanics and 10.5 percent of non-Hispanic whites were poor (*Chart 1B*).¹

Hispanic performance has also been disappointing when compared with other minorities nationally. Hispanic poverty rates have fallen 12 percentage points in Texas but less than 1 percentage point in the U.S. over the past 40 years. Black poverty declined 12 percentage points in Texas and 9 percentage points in the U.S. during the same period. Although Hispanics have logged much greater improvement in Texas than in the U.S. since 1970, their poverty rates remain higher here.

In the U.S. Census and the American Community Survey, Hispanic is an ethnicity that can fall into any race category and is based on self-identification. A total of 50.5 million people—16.3 percent of the U.S. population—consider themselves Hispanic, according to the 2010 census. Of those, 9.5 million reside in Texas, representing 37.6 percent of the state population. In Texas, the Hispanic population grew 42 percent between 2000 and 2010; nationally, it increased 43 percent. As a result, the Hispanic population's well-being plays an increasingly important role in regional and national economic prosperity. Hispanic workers' skills and education will help determine the future productivity of the labor force and competitiveness of U.S. industry.

Immigrant–Native Differences

Rapid immigration could explain why Hispanic poverty rates have not kept

pace with improvements realized by other relatively poor minorities that experienced much less influx from abroad—such as non-Hispanic blacks. Hispanic immigrants tend to have low levels of English fluency and education, which are correlated with poverty. Indeed, overall poverty statistics (depicted in *Charts 1A* and *1B*) mask considerable progress among Hispanics born in the U.S., the native born.

The poverty rate of native-born Hispanics has declined over the past four decades and was 7 percentage points less than that of foreign-born Hispanics in 2010 (*Chart 2*). The native born benefit from more education, better English proficiency and U.S. citizenship.² Growth in the number of native-born Hispanics—accounting for more than 46 percent of the nation's Hispanics age 16 and older—has outpaced immigrant inflows since 2000.³

The poverty rate of native-born Hispanics was still 10 percentage points higher than that of non-Hispanic whites in 2010, even with Hispanics' improved economic state. One contributor is Hispanic household heads' relative youth—poverty tends to be more pervasive among younger families and declines over time. Because earnings rise with age at a decreasing rate, poverty will fall faster for Hispanics than for non-Hispanic whites, narrowing the gap in coming years.

Poverty Rates Fall with Time in U.S.

Although Hispanic immigrants have the highest poverty rates, these rates fall as immigrants spend more time in the U.S. (*Chart 3*). The Hispanic immigrant cohort that arrived in 1965–70 experienced a poverty rate of 24.7 percent in 1970, 17.5 percent in 1980 and 16 percent by 2010. Hispanic immigrants arriving in 1975–80 initially had a 31.6 percent poverty

rate, which fell to 25 percent a decade later and to 17.2 percent by 2010.

Every immigrant cohort pictured experienced sharp poverty rate declines during the first two decades following arrival. However, the chart reveals that the initial poverty rate has increased across cohorts. For immigrants who arrived in 1965–70, 24.7 percent lived in poverty in 1970; for arrivals in 1975–80, 31.6 percent lived in poverty in 1980. Rising immigration from Mexico and Central America accounts for much of the trend. Those groups have less education on average than earlier waves of Hispanics from places such as Cuba and Puerto Rico.⁴

What Contributes to Poverty?

Among household heads, the poverty gap between Hispanics and non-Hispanic whites was 13 percentage points in 2010. The gap can be decomposed into two sets of contributing factors—the differences in characteristics between the two groups, and the differences in labor market rewards (or penalties) for those characteristics.⁵ The focus here is on the former, the contribution of the two groups' differing attributes to the poverty gap. Age is one factor—Hispanics are younger than non-Hispanics, on average, and younger people tend to be poorer. The poverty rate among Hispanics would drop if their average age were the same as that of non-Hispanic whites. We also examined the importance of the household head's immigrant status, education, English ability and year-round employment.⁶ We note whether the household head is a single female, in addition to household characteristics such as the number of children, family size and residential location.

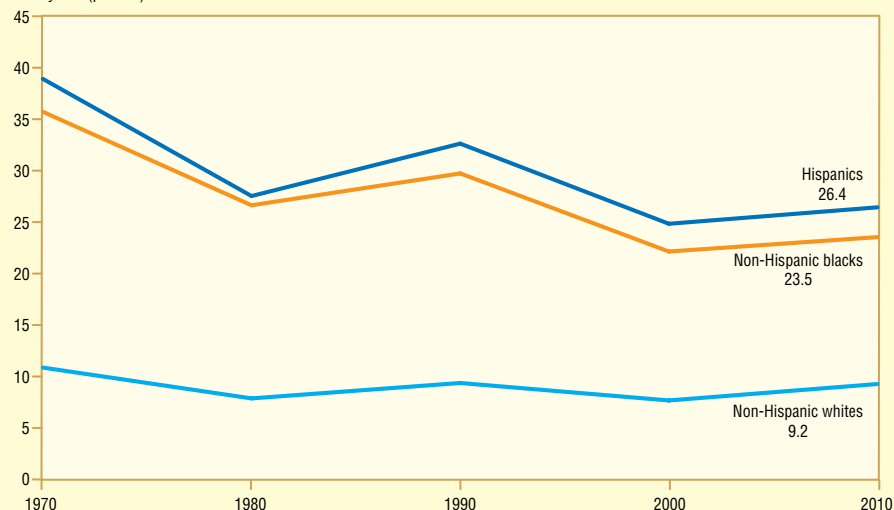
Poor English-speaking ability makes the largest contribution to the poverty gap, explaining 6.1 percentage points of the 13 percentage-point poverty gap between Hispanics and non-Hispanic whites (*Chart 4*). In other words, absent the language barrier, the poverty gap would be 6.9 percentage points.

Differences in educational attainment explain 1.3 percentage points of the gap. This number probably understates the importance of schooling since it assumes both groups received the same quality of instruction. In reality, studying in the U.S. provides higher returns than learning abroad. Whether the head was employed year-round accounts for 1.7 percentage points of the poverty gap; the household head's age accounts for another 1.8 percentage points of the gap.

Chart 1 Poverty a Persistent Problem for Hispanics

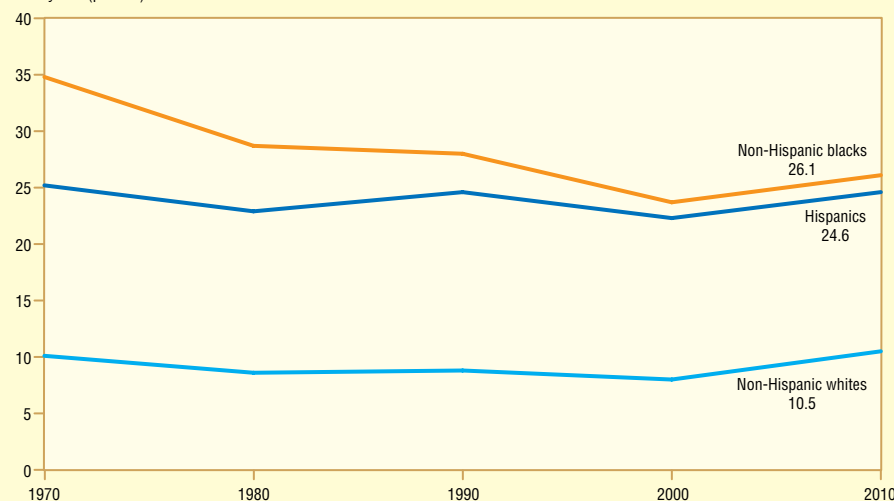
A. Texas Gap Remains Wide

Poverty rate (percent)



B. U.S. Rates Barely Budge

Poverty rate (percent)



SOURCES: Authors' calculations based on Integrated Public Use Microdata Series data from the 1970–2000 census and 2010 American Community Survey (ACS). Census data reflect income during the previous calendar year; ACS data reflect income during the previous 12 months.

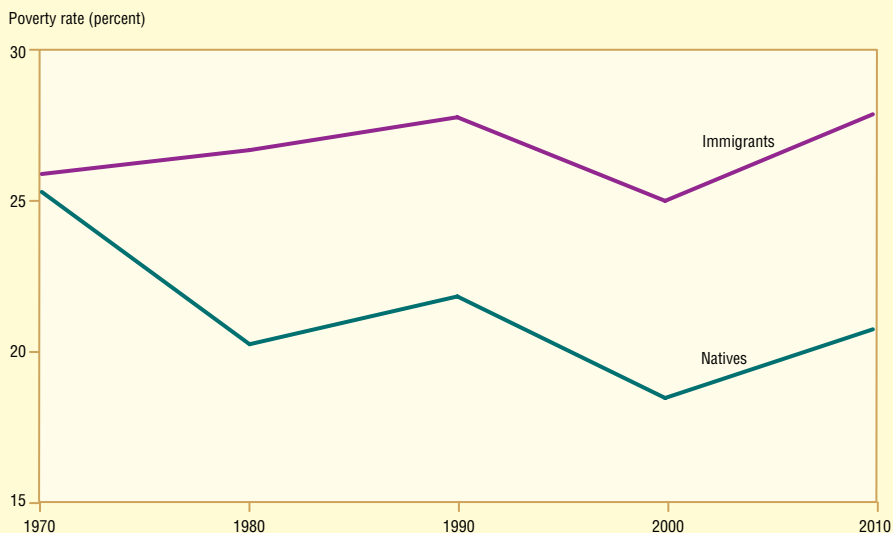
The number of children in the household—which is larger (by 0.6 children) for Hispanics than for the non-Hispanic white group—is responsible for 1.1 percentage points of the gap. After controlling for the number of children, other differences in family size actually reduce the poverty gap by 0.7 percentage points, probably because Hispanic households include more adults than do non-Hispanic white families. The number of female-headed households does not significantly affect the poverty gap, even though half of all Hispanic children are now born to unmarried women, most of whom are themselves U.S. born.⁷

The choice of urban-area location and state of residence decreases the gap by 0.7 percentage points. This may be surprising since many Hispanics live in areas with low-income housing and underperforming schools.⁸ However, these circumstances are offset by Hispanics living in or moving to parts of the country with strong economic growth, such as the Southwest (including Texas), the South and the Mountain West.

Meanwhile, the household head's immigrant status contributes 0.5 percentage points to the poverty gap, a comparatively small number. This effect is so small because English ability and education capture much

Poor English-speaking ability makes the largest contribution to the poverty gap, explaining 6.1 percentage points of the 13 percentage-point gap between Hispanics and non-Hispanic whites.

Chart 2
Hispanic Native Poverty Rate Falls Over Past 40 Years



SOURCES: Authors' calculations based on Integrated Public Use Microdata Series data from the 1970–2000 census and 2010 American Community Survey (ACS). Census data reflect income during the previous calendar year; ACS data reflect income during the previous 12 months.

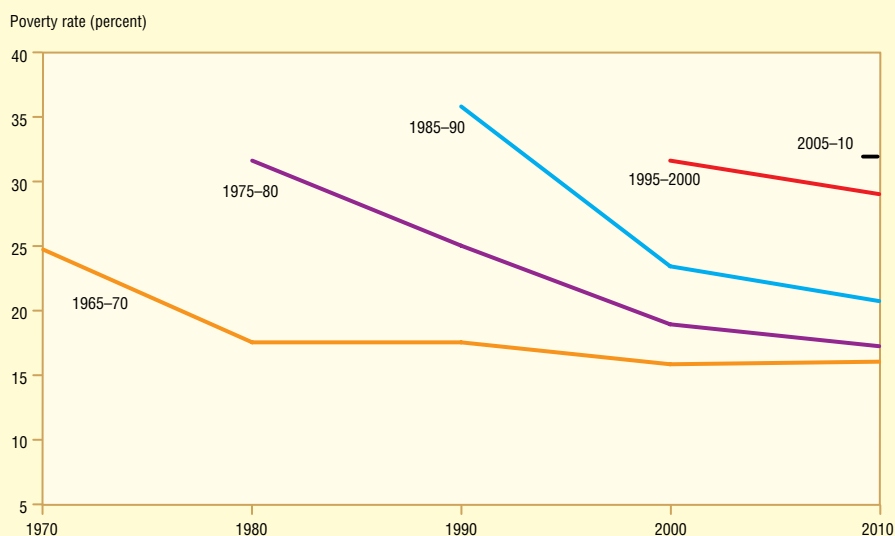
of the difference between Hispanic natives and immigrants.

Differences in characteristics cannot explain 1.8 percentage points of the poverty gap. This portion of the gap is due to differences in how the labor market values characteristics among Hispanics and non-Hispanic whites. For example, non-Hispanics may earn a higher return on education than Hispanics, on average, because they are

more likely to be U.S. educated. However, discrimination can also play a role.

This decomposition of the poverty gap doesn't consider such factors as comparatively less work experience, living in states with low minimum wages and lower rates of unionization. More importantly, the lack of legal status and the Great Recession are key contributors to Hispanic poverty. About half of foreign-born Hispanics are undocumented immigrants. They earn less, change jobs more frequently and receive less government aid. As a group, Hispanics' relatively lower educational attainment and their employment concentration in economically sensitive sectors such as construction increase their vulnerability to the economic downturn.⁹

Chart 3
Hispanic Immigrant Cohorts: Poverty Drops with Time in U.S.



SOURCES: Authors' calculations based on Integrated Public Use Microdata Series data from the 1970–2000 census and 2010 American Community Survey (ACS). Census data reflect income during the previous calendar year; ACS data reflect income during the previous 12 months.

The Outlook for Hispanics

The future of the U.S. Hispanic population depends on its rapidly growing native-born segment. Improving education is crucial to closing the poverty gap, a goal helped by new generations that assimilate and attain higher education levels.¹⁰ Although 49 percent of Hispanic immigrants don't have a high school degree, only 20 percent of the second generation and 18 percent of the third generation and beyond lack one. While that is impressive improvement, it compares with just 8 percent of non-Hispanic whites who lack high school completion.

Ironically, while Hispanic natives

acquire far more education than their immigrant parents, they lose some positive attributes of the first generation as they assimilate. Hispanic immigrants have high labor force participation rates, high geographic mobility, high marriage rates and low nonmarital birth rates. Their children are less geographically mobile and are experiencing rising out-of-wedlock births, a troubling trend given that households headed by women tend to have elevated poverty rates. Other concerns include the growing elderly Hispanic population, which is less likely to receive pension or Social Security benefits, contributing to a high poverty incidence.

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Notes

This article is based on "Trends in Poverty and Inequality Among Hispanics," by Pia Orrenius and Madeline Zavodny, in *The Economics of Inequality, Poverty and Discrimination in the 21st Century*, Robert S. Rycroft, ed., Santa Barbara, Calif.: ABC-CLIO, Praeger, forthcoming 2012.

¹ The Census Bureau uses money income thresholds that vary by family size and composition to determine poverty. If a family's total income is less than the family's threshold, that family and every individual in it is considered in poverty. The poverty rate is the percentage of people below poverty. In this article, income measures in the decennial census data are based on incomes during the previous calendar year, while 2010 American Community Survey (ACS) data are based on income over the 12 months prior to the interview. Decennial census and ACS data are both from the Integrated Public Use Microdata Series database ("Integrated Public Use Microdata Series: Version 5.0," by Steven Ruggles, J. Trent Alexander, Katie Genadek, Ronald Goeken, Matthew B. Schroeder and Matthew Sobek, University of Minnesota, 2010).

² In the comparison of native and immigrant households, immigrant status is based on the birthplace of the head of household; native-born children with immigrant parents are classified as immigrants. Were these children classified as natives, native-born Hispanic poverty rates would be much higher. Children are more likely than adults to be poor, and Hispanic children are especially likely to be poor. More than a third of all Hispanic children lived in poor families in 2009.

³ See "U.S. Population Projections: 2005–2050," by Jeffrey S. Passel and D'Vera Cohn, Pew Hispanic Center, Washington, D.C., 2008.

⁴ For purposes of this paper, Puerto Ricans—even though they are U.S. citizens—were grouped with Hispanic immigrants.

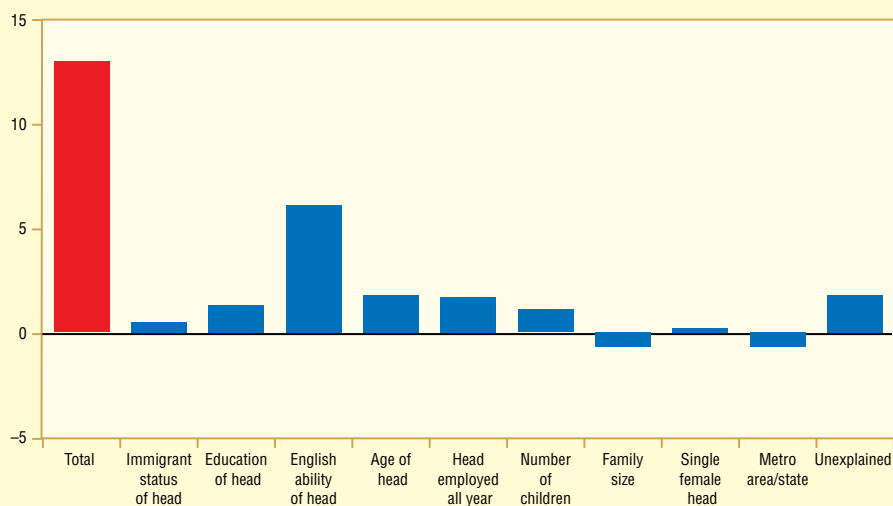
⁵ This technique is called the Blinder–Oaxaca decomposition, and we use the 2010 American Community Survey.

⁶ Education is measured in four categories: no high school diploma or equivalent, high school diploma or equivalent, some college and college graduate. English ability is measured using

Chart 4

What Explains the Poverty Gap? Hispanics vs. Non-Hispanic Whites

Poverty rate (percent)



SOURCES: Authors' calculations based on Integrated Public Use Microdata Series data from the 2010 American Community Survey.

the five categories for self-reported English ability: speak English only and speak English very well, well, not well and not at all.

⁷ See "Births: Preliminary Data for 2009," by Brady E. Hamilton, Joyce A. Martin and Stephanie J. Ventura, *National Vital Statistics Reports*, vol. 59, no. 3, Hyattsville, Md.: National Center for Health Statistics, 2010.

⁸ See "Nowhere Near the Same: The Neighborhoods of Latino Children," by Richard Alba, Nancy A. Denton, Donald J. Hernandez, Ilir Disha, Brian McKenzie and Jeffrey Napierala, in *Growing Up Hispanic: Health and Development of Children of Immigrants*, Nancy S. Landale, Susan McHale and Alan Booth, eds., Washington, D.C.: The Urban Institute Press, 2010, pp. 3–48.

⁹ See "Mexican Immigrant Employment Outcomes over the Business Cycle," by Pia M. Orrenius and Madeline Zavodny, *American Economic Review Papers and Proceedings*, vol. 100, no. 2, 2010, pp. 316–20.

¹⁰ See "Assimilation Across the Latino Generations," by James P. Smith, *American Economic Review Papers and Proceedings*, vol. 93, no. 2, 2003, pp. 315–19; also see "Immigrants and the Labor Market," by James P. Smith, *Journal of Labor Economics*, vol. 24, no. 2, 2006, pp. 203–34.



AGRICULTURE: Pecan Prices Remain Strong, but Drought Hurts Production

Pecan prices remained high in Texas last year, reflecting a drought-restrained harvest, growers say. Nationally, prices rose to \$2.30 per pound in 2010 from \$1.34 two years earlier.

The U.S. is the world's top pecan producer, and among the states, Texas has the second-largest harvest after Georgia. Texas' 70-million-pound production in 2010 was valued at \$159 million. Pecan trees produce in two-year cycles that lead to heavy production one year (called the “on year”) and light production the next year (the “off year”). On years in Texas yield around 70 million pounds, off years about 40 million pounds. Though 2010 was a historically established off year, production was more in line with an on year.

Asian demand and industry marketing efforts highlighting pecans' health benefits have helped boost prices. U.S. pecan exports to China, Hong Kong and Vietnam have increased 13-fold over five years.

Texas growers couldn't take full advantage of high prices in 2011, an on year, because of production lost to the drought. The 2011 crop likely totaled about 40 million pounds, the U.S. Department of Agriculture estimated. The extent of damage remains unknown; production from damaged and distressed trees in 2012 will reveal the drought's lasting effects.

—Yingda Bi



POPULATION GROWTH: Texas' 10-Year Increase Leads the States

Texas' population reached nearly 25.7 million in July 2011 after gaining 4.3 million, or 20.4 percent, in the past decade, according to Census Bureau population estimates. Texas has again posted the largest population increase over a 10-year period among the states. In terms of percent growth, Texas advanced one spot to fourth place, trailing Nevada, Utah and Arizona.

Over the past decade, net domestic and international migration have accounted for roughly 45 percent of growth in Texas. In the early 2000s, this increase was largely due to high international migration, but as the recent financial crisis unfolded, the amount of net international migration was halved in Texas and nationally.

Texas has been the No. 1 destination for domestic migrants since 2006. Between July 2010 and July 2011, Texas gained more than 115,000 new residents from other states, net of those who left the state. This represents a doubling of the average net domestic movement from the rest of the U.S. to Texas over the past 10 years.

Many of these arrivals were likely drawn by the strength of the Texas economy. Texas metros occupy four of the top five slots in the Milken Institute's 2011 rankings of U.S. metropolitan areas by economic growth and job creation, and Houston was first among the 10 largest metros.

—Christina Daly



VENTURE CAPITAL: Texas Spending Rebounds from Recession Low

Venture capital spending in Texas increased during third quarter 2011 by more than 100 percent on a quarter-over-quarter basis, to almost \$600 million. The figure was 59 percent more than the year-earlier period. The activity, marking the single strongest quarter for Texas since 2001, continues a recovery from recession lows reached in 2009.

Texas' share of total U.S. venture capital rose to 8.6 percent, above its long-term average of about 5 percent. The only states receiving a greater share were perennial leaders New York and California. However, Texas' share measured on a trailing four-quarter basis remained at its long-term average.

Biotechnology-focused investment drove the Texas increase, accounting for 52 percent of all funds invested, above

the usual range of 0–15 percent. Industrial and energy investment fell slightly from the second quarter but remained near the highest levels seen since 2008, likely driven by elevated oil prices. Media and entertainment spending declined, while medical device and equipment expenditures rebounded to a more normal level from virtually zero in the second quarter.

Given the third quarter's unusually high level of biotechnology investment, a falloff might be expected in both biotechnology and total venture capital spending during the fourth quarter. However, that wouldn't necessarily be a negative indicator, since quarterly spending has significantly rebounded from early 2009.

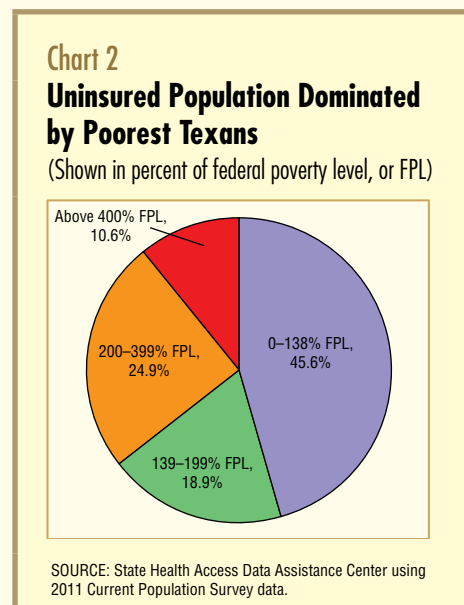
—Jackson Thies

Health Care Reform Reducing Ranks of Uninsured Texans Comes at a Price

Texas has the highest percentage of residents without health insurance in the nation. About 27 percent of nonelderly Texans, or 6.1 million people, don't have coverage (*Chart 1*). The rest of the population is insured through an employer, private individual insurance or a public plan such as Medicaid. Congress approved health care reform, known as the Affordable Care Act, in March 2010 in part to reduce the ranks of the uninsured.

While most of the act's spending and new regulations begin in 2014, some provisions have already taken effect. The federal government created the Pre-Existing Condition Insurance Plan for people with chronic illnesses who cannot obtain insurance in the private market.¹ This high-risk pool offers subsidized premiums so individuals pay only the average rates charged for similar coverage. As of November 2011, only 3,600 Texans were enrolled—out of an estimated 700,000 uninsured with a preexisting condition—perhaps because of entry requirements, lack of publicity or affordability. Texas is allotted \$493 million for the risk pool over 3.5 years.

Other regulations already in place allow young adults under age 26 to remain on their parents' plans, ensure that most children cannot be denied coverage due to preexisting conditions and require new plans to cover



preventive care without copayments.

Starting in 2014, insurance companies can't reject enrollees or charge different rates based on preexisting conditions, health history and gender. In return, most people will be required to have health insurance or pay a fine.² Health insurance exchanges will be formed as a marketplace for plans and consumers.

To assist with the cost of buying insurance, subsidies will be given to citizens and legal permanent residents with incomes between 133 percent and 400 percent of the federal poverty level (FPL). Those percentages equate to yearly incomes between \$30,657 and \$92,200 for a family of four in 2012. In addition, Medicaid will be expanded to nearly all nonelderly citizens below 138 percent of the FPL.³ In Texas, 44 percent of the uninsured fall between 139 percent and 400 percent of the poverty line, and 46 percent are at or under 138 percent of the poverty line (*Chart 2*).⁴

The act also requires employers with more than 50 employees to make "meaningful" contributions to health insurance or pay an annual fine of \$2,000 per full-time employee (minus the first 30 employees).⁵ Those with fewer than 25 employees may qualify for tax credits for their insurance contributions (those with 25 to 49 receive neither a tax credit nor fine).

Federal health reform is funded through three main avenues: expected savings to the

Medicaid and Medicare programs; new taxes on the medical industry, individuals with incomes of more than \$200,000 (\$250,000 for couples) and high-cost insurance policies (dubbed "Cadillac" plans); and tax penalties on individuals and companies that don't purchase or provide insurance.⁶

Consumers may face higher premiums, which tend to increase annually as health care costs rise. The new regulations may also play a role in higher premiums. Average premiums increased 9 percent in 2011 for employer-based family coverage across the nation, compared with 3 percent in 2010 and 5 percent in 2009, according to the Employer Health Benefits survey.⁷ Aggregate health spending in 2010 increased 3.9 percent, 0.1 to 0.2 percentage points of which were attributed to the act.⁸

—Yingda Bi

Notes

¹ The federal high-risk pool was established in addition to the Texas Health Insurance Pool created by the state before federal health reform.

² A U.S. Supreme Court decision is pending about the constitutionality of the so-called individual mandate.

³ The law specifies Medicaid expansion to 133 percent of federal poverty level based on modified adjusted gross income with a special adjustment of 5 percentage points.

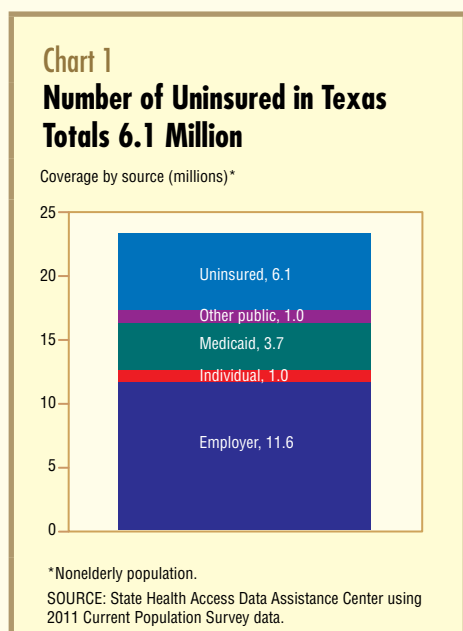
⁴ An estimated 1.7 million unauthorized immigrants live in the state. They are ineligible to participate in Medicaid, insurance exchanges and federal subsidies.

⁵ For more detailed information, see the Congressional Research Service's summary of potential penalties at www.lrgov.ri.gov/smallbusiness/employerprovisions.pdf.

⁶ Some observers question whether projected cost savings will be realized. See "Federal Health Care Law Promises Coverage for All, But at a Price," by Jason Saving, Federal Reserve Bank of Dallas *Economic Letter*, vol. 6, no. 2, 2011, www.dallasfed.org/research/eclett/2011/el1102.html.

⁷ "Employer Health Benefits," the Kaiser Family Foundation and Health Research and Educational Trust annual survey, 2011, <http://ehbs.kff.org/pdf/2011/8225.pdf>. Premium growth is not adjusted for inflation.

⁸ "Growth in U.S. Health Spending Remained Slow in 2010; Health Share of Gross Domestic Product Was Unchanged from 2009," by Anne B. Martin, David Lassman, Benjamin Washington, Aaron Catlin and the National Health Expenditure Accounts Team, *Health Affairs*, vol. 31, no. 1, 2012, pp. 208–19.



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