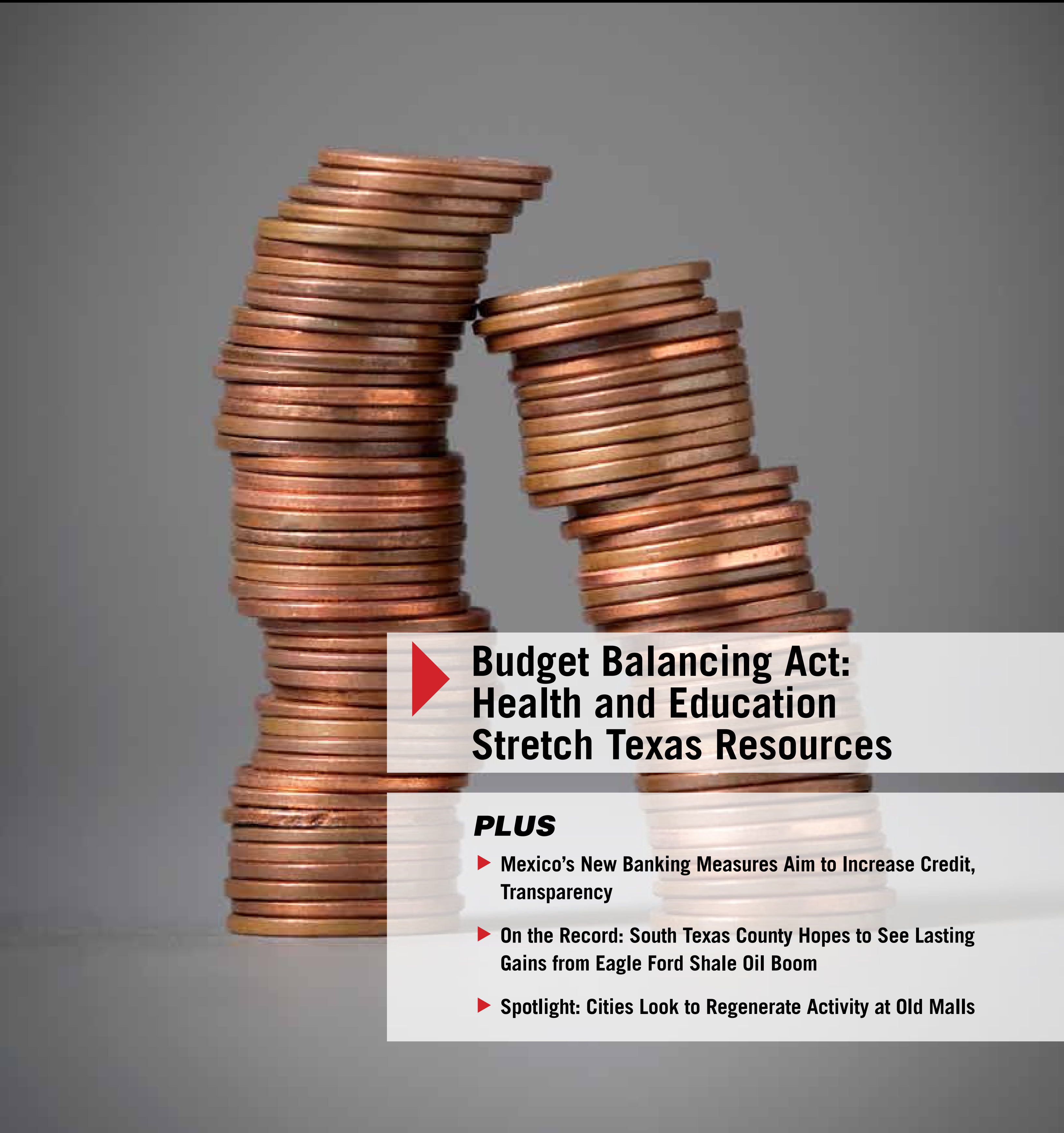
DALLASFED

THIRD QUARTER 2014

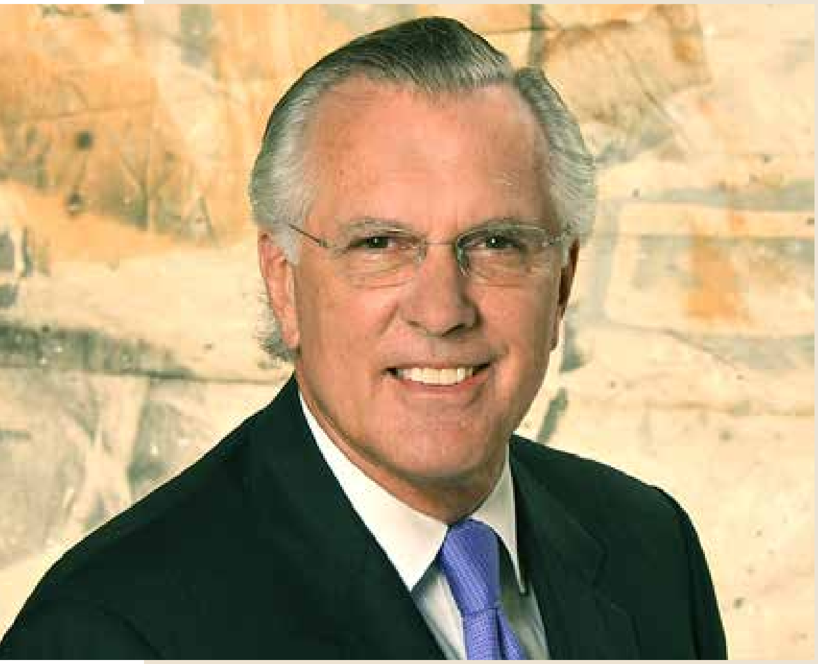
Southwest Economy



Budget Balancing Act: Health and Education Stretch Texas Resources

PLUS

- Mexico's New Banking Measures Aim to Increase Credit, Transparency
- On the Record: South Texas County Hopes to See Lasting Gains from Eagle Ford Shale Oil Boom
- Spotlight: Cities Look to Regenerate Activity at Old Malls



It's no secret that Texas' economic growth has led the nation during the economic expansion and helped drop the state's unemployment rate to a six-year low. Without the 1.1 million jobs created in Texas since December 2007, the nation would still be 350,000 jobs below its prerecession employment peak. However, improvement in the state's fiscal picture lagged behind, and in mid-2011, state lawmakers confronted a $20 billion budget shortfall and reduced Texas outlays by 10 percent.

With the memory of those painful cuts still fresh in our minds, it is reassuring to learn that the state's fiscal outlook is solid even as total spending reaches all-time highs, senior research economist Jason Saving notes in this issue of *Southwest Economy*. Texas' 8 percent revenue growth in the first half of the year—bolstered by an annual contribution from sales tax that is larger than all of Texas' other taxes combined—is nearly double the average 4.2 percent revenue growth for the rest of the states.

Without the revenue growth, the state cannot pay for education and the rising costs of health care (which together represent 75 percent of the state budget). The state's population has grown to 26.5 million, and a workforce of 11 million Texans produces $1.5 trillion worth of goods. As the economy prospers and the population grows, legislators must strike a delicate balance between investing in important state services and projects while not sacrificing the low-tax, lightly regulated business climate that has helped propel Texas' superior economic performance.

Legislators must strike a delicate balance between investing in important state services and projects while not sacrificing the low-tax, lightly regulated business climate that has helped propel Texas' superior economic performance.

Heading into the final quarter of the year, the Texas and U.S. economies are poised to finish strong. And although fiscal challenges and difficult choices remain, Texas' ability to balance its fiscal responsibilities with available resources stands as an example to our national leaders of the benefits of prudent stewardship.

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

Budget Balancing Act: Health and Education Stretch Texas Resources

By Jason Saving

ABSTRACT: Texas legislators confront a key challenge: how to make much-needed investments in health, education and transportation without sacrificing the fiscal structure that has propelled the economy over the last few decades.

Just three years ago, following the Great Recession, Texas found itself in dire fiscal straits. Legislators convening to write the 2012–13 biennial budget were confronted with a shortfall exceeding $20 billion.[1] They closed the gap, which amounted to 10 percent of their original spending plan, through a combination of spending reductions and revenue increases.

As a result, the 2012–13 budget fell in dollar terms—an unusual occurrence (*Chart 1*). The ensuing debate centered on the sources of Texas' funding and how that money is spent. There were suggestions that education, health and transportation expenditures not be reduced—without fully taking into account what proportion of the budget they consume or whether it was even possible to undertake significant cuts without touching those areas.

Others, looking at funding sources, noted that many of the taxes levied by the state, such as on energy and alcohol, held up reasonably well during the difficult economic times. But, they wondered, are the taxes that remained reasonably strong during the recession representative of where the state gets most of its revenue?

At the midpoint of fiscal 2014, a steadily improving economy has substantially bolstered the state's fiscal outlook.[2] Total spending reached a new high (though still lower than 2010–11 on a per capita basis) and state revenue has grown at a robust pace.

Revenue has risen faster in Texas than in most of its large-state counterparts—though less than in California, which is finally emerging from a much deeper recession than Texas experienced (*Chart 2*). Overall, the state's 8 percent revenue growth is nearly double the 4.2 percent rate for the rest of the nation, underscoring that the Texas fiscal situation not only is improving but is doing so at a more rapid pace than in the rest of

Chart 1 Fiscal Pressures Caused Rare Decline in 2012–13 Budget

Billions of nominal dollars

SOURCE: Texas Comptroller of Public Accounts.

the country.

Still, the recent uptick doesn't preclude that austerity may once again be required sometime in the future. Through good times and bad, legislators confront a key challenge: how to make much-needed investments in health, education and transportation infrastructure without sacrificing the lean and efficient fiscal structure that has helped the state's economy to outperform the nation over the last few decades.

Moreover, within the budgetary calculus, the sales tax is a particularly important revenue source, and education and health services (together accounting for three-quarters of state spending) are key recipients whose size invariably makes them targets for spending cuts.

Tax Revenue Sources

The state imposes a variety of taxes and fees—including a cement production tax, a fireworks tax and a coastal protection tax—most of them unfamiliar to the average Texan. But not all state taxes are created equal; the sales tax is vastly larger than other levies (*Chart 3*).

The Limited Sales and Use Tax, introduced in 1961, imposed a 2 percent levy on most retail purchases, although like today, there were exemptions for certain goods, such as groceries, whose taxation would disproportionately impact the poor. This was done in an effort to make the sales tax more progressive than it would otherwise be. The current statewide rate of 6.25 percent was authorized in 1990.

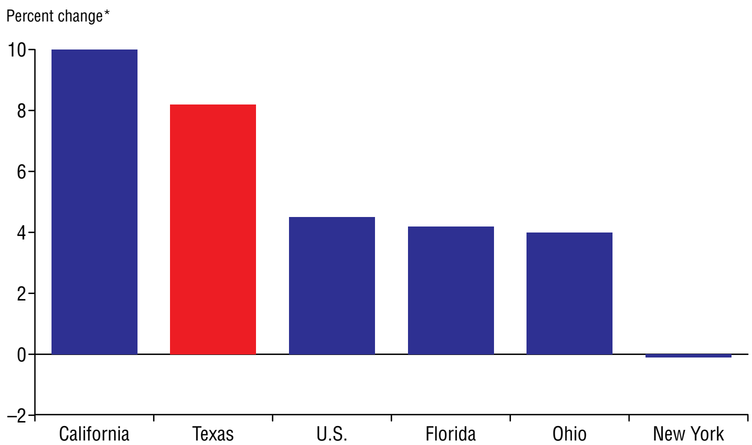
The sales tax accounted for 54.3 percent of all state tax revenue in 2013, the last year for which complete data are available (*Chart 4*). Over the last seven years, that proportion has changed only slightly, starting at 54.8 percent of revenue in 2007 and remaining within 3 percentage points since.

Economists generally find that people's consumption is more stable than their income from year to year. Income can fall to zero when someone is laid off, but food, clothing and shelter are still purchased. Thus, levies such as the income tax tend to swing dramatically with the business cycle, tumbling during downturns and recovering just as dramatically during recoveries.

The second-largest state tax revenue source is the franchise tax, a business assessment on gross receipts. The tax, a form of which dates back to the 19th century, is essentially a payment for the right to conduct business. Firms are taxed on their total revenue minus their wage or merchandise costs (whichever is greater) up to a maximum of 70 percent of their revenue. While initial discussions called for all but the smallest of businesses to be taxed, the current incarnation exempts the first $1 million in revenue, which removes the bulk of enterprises from the reach of the franchise tax.

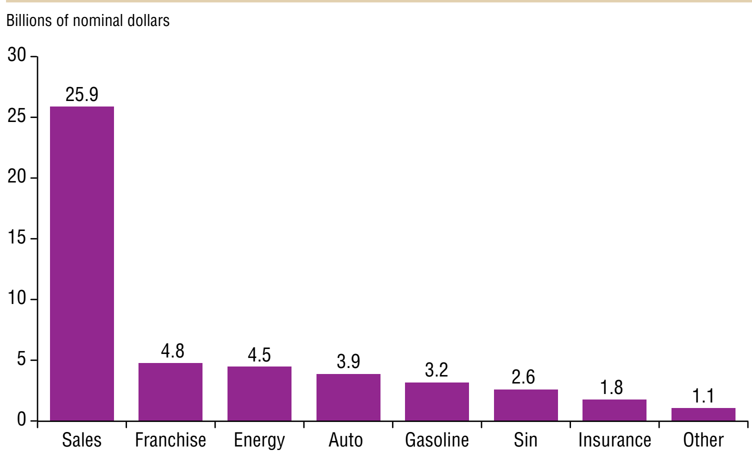
The franchise tax is commonly confused with a corporate income tax. But there is an important difference—firms that lose money can still owe franchise tax if their revenue is high enough, whereas a money-losing firm would not generally incur an income tax liability. Yet the franchise tax is also not a straight tax on revenue because of the deductions it allows for compensation or merchandise costs. The state Supreme Court has provided legal clarification about the franchise tax, ruling that it is not a corporate income tax despite certain similari-

Chart 2 Texas Revenue Growing Faster than National Average



*First half of FY2014 compared with first half of FY2013.
SOURCE: Rockefeller Institute.

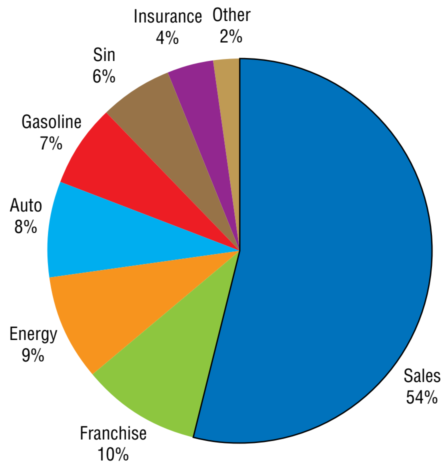
Chart 3 Sales Tax Top Source of Texas Tax Revenue



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

Chart 4

Sales Tax Larger Than All Other State Taxes Combined



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

ties—an important distinction in Texas, whose constitution bans individual and corporate income taxation.

The franchise tax accounted for 10.1 percent of state revenue—less than one-fifth the amount the sales tax provided in fiscal 2013. Franchise tax revenue has also exhibited volatility over time, falling to 8.5 percent of state revenue in 2007, though it has generally remained within a percentage point or two of its 2013 level.

Next are the state's energy taxes: a natural gas production tax and an oil production/regulation tax. Most striking is the degree to which these taxes swing as economic conditions change. In the 2007–13 period, these levies ranged from a low of 4.9 percent of state tax revenue in 2010 to highs of 10 percent in 2008 and 9.4 percent in 2013 (*Chart 5*).

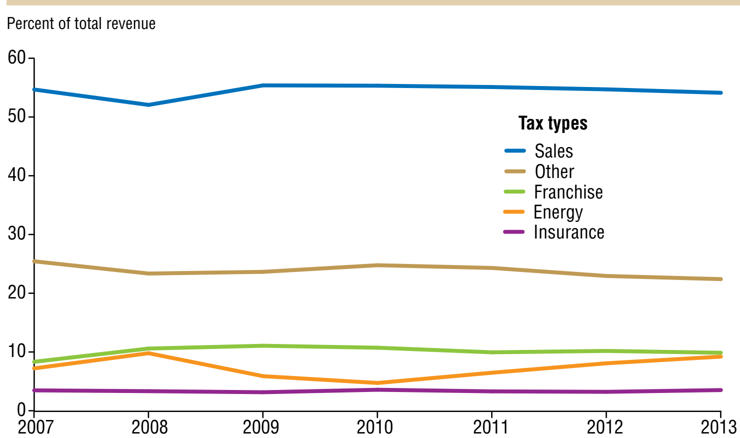
It isn't surprising that oil and gas revenue would strengthen during a period of exceptionally strong energy production. However, the near doubling of its share of overall revenue illustrates the conundrum associated with narrow sectoral taxes: Revenue rises dramatically during good times for the sector but can fall just as dramatically, often when a state can least afford it. Even so, the contribution of energy taxes to the state's fiscal coffers remains modest.

Other state taxes include automobile taxes, the gasoline tax, "sin" taxes on alcohol and tobacco, insurance taxes and a grab bag of lesser levies such as the previously mentioned cement and fireworks taxes. These smaller sources collectively account for about one-quarter of state tax revenue.

Two other kinds of taxes provide no revenue for the state. The individual income tax—levied in 43 of the 50 states—has been banned in Texas since 1993 following a failed effort to introduce one. The second is the property tax, which school districts and other local government entities collect.[3]

Chart 5

Tax Trends Relatively Stable, Except for Energy



SOURCE: Texas Comptroller of Public Accounts.

Funding Education, Health Care

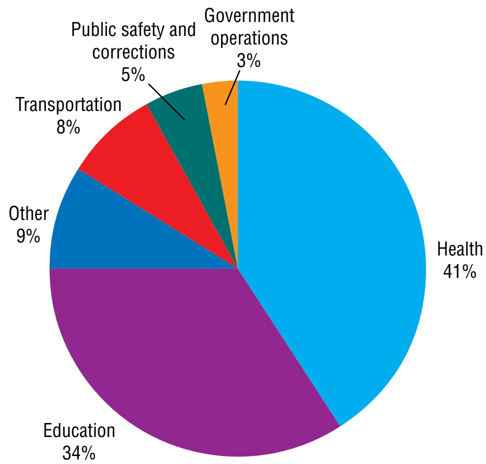
States provide many services for their residents, from operating state parks to staffing driver's license offices. But the bulk of state spending in Texas—as in most other states—is devoted to health and education.

Health spending accounted for 41 percent of the state budget in fiscal 2013 (*Chart 6*). These expenditures flow primarily to Medicaid recipients, though they also include other programs such as the Children's Health Insurance Program and some public hospital funding. Health outlays have expanded rapidly in recent years amid soaring medical costs and a state population growth rate that was double the nation's. As late as 2007, health and education spending were roughly equal in Texas, but by 2013 health had grown 20 percent larger than education (*Chart 7*).

While health spending is a large and growing portion, Texas ranks last in the proportion of its residents with some form of health insurance coverage. To be sure, part of this stems from the state's large undocumented population, which is more likely than citizens and legal residents to lack coverage. But part of it results from the exceptionally low income level at which Medicaid eligibility is cut off in Texas: just 20 percent of the federal poverty line, the second-lowest cutoff in the nation.

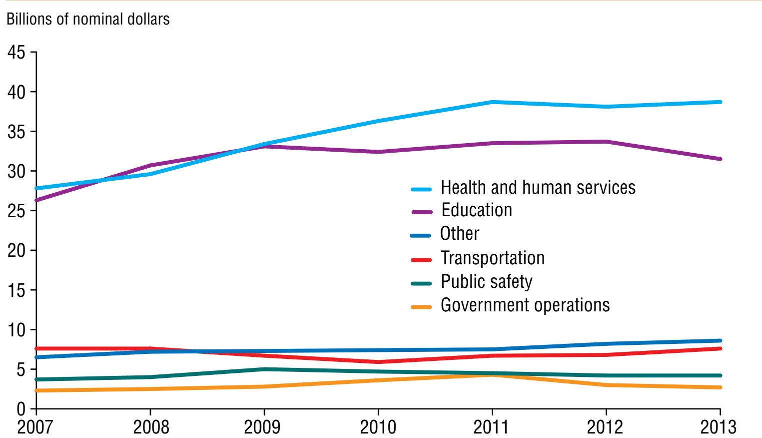
Education spending accounted for one-third (33.7 percent) of the state bud-

Chart 6 State Outlays Flow Mostly to Health and Education



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

Chart 7 Medicaid and Other Health Expenditures Make Up Largest Component of Budget



SOURCE: Texas Comptroller of Public Accounts.

get in fiscal 2013. This expenditure is split roughly evenly between K–12 education (which the state funds in conjunction with local school districts) and state colleges and universities.

Even with such a large share, Texas lags other states in per-capita education outlays. The National Education Association estimated that Texas ranked 46th among the 50 states in per student K–12 education spending in 2012–13.[4] Yet educators were remarkably efficient using what they received, at least by some measures: Texas fourth-grade math test results placed students 24th in the nation, with each ethnic group in the state outperforming its national peers on the exam.[5]

Transportation and infrastructure represents the third-largest Texas outlay, accounting for 8.1 percent of expenditures in 2013. This spending is primarily devoted to roads and bridges, which recently received a grade of C from the American Society of Civil Engineers—unexceptional though slightly above the national average of D+. An estimated $4 billion per year in additional funding would be needed to fully address infrastructure needs, implying any sustained rise in transportation spending would come at the expense of education or health care—areas where few believe existing needs are adequately met with current funding though they dominate the budget.[6]

Public safety and corrections—seen by many as the cornerstone of state government services—ranks fourth, at 4.6 percent of state expenditures. This broad category encompasses state law enforcement personnel, prisons and certain associated equipment and training.

Surprisingly, spending to operate the machinery of state government—the executive, legislative and judicial branches—collectively consumes only 2.9 percent of state expenditures. The remaining 9.3 percent is primarily devoted to employee benefits and natural resources and recreation, along with other smaller items.

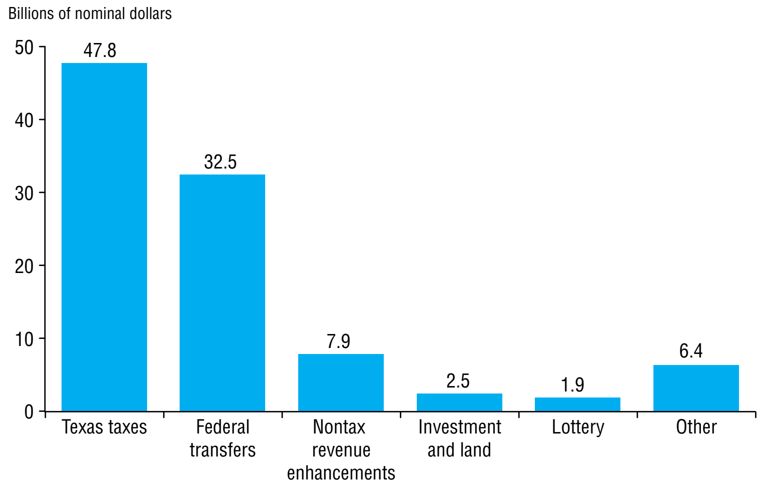
Array of Additional Funds

Texas collected $47.8 billion in tax revenue in fiscal 2013. However, it spent $93.6 billion during that period. An array of additional funds allows the state to comply with a balanced-budget requirement mandating estimated revenue equal projected expenditures.

Texas received a total $99 billion, with the federal government contributing $32.5 billion (*Chart 8*). The federal sum represented 32.8 percent of state revenue, exceeding the sales tax's 26.1 percent and dwarfing the other taxes Texas imposes. The majority of the federal money is earmarked for health (65.3 percent), education (17.9 percent) and transportation (8.8 percent), though a small amount comes in the form of grants for a variety of purposes.

Another significant source is what legislators sometimes call "nontax revenue enhancements"—assessments that raise money for the state but aren't officially considered taxes. This category covers more than 200 revenue sources, including marriage and sport licenses, driver's licenses and any surcharges for point penalties from traffic law violations, coin-operated (gambling) machine licenses and bingo prize fees, exam fees for teachers and boaters, combative sport

Chart 8 Federal Transfers Are Key Revenue Source for Texas



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

licenses (for boxers and martial artists) and fees for the use of state parks. Nontax revenue enhancements collectively contributed $7.9 billion to state revenue in 2013—about as much as the franchise and gasoline taxes combined.

Other revenue sources available to the state include interest and investment income, lottery proceeds and land income, as well as the sale of certain goods and services to localities or the public. Combining these with the other revenue sources yields the state's $99 billion in receipts during fiscal 2013.

Future Funding Challenges

Texas has become the nation's second-largest state, with 26.5 million residents and annual economic output (state gross domestic product) of $1.53 trillion. The state has a large and complex set of revenue and expenditure sources that need to be understood as future tax and spending decisions are made. While expenditures flow to many areas, education and health care consume 75 percent of the state budget.

Looking to the future, lawmakers must keep a watchful eye over challenges facing Texas' main revenue source—the sales tax. The growing presence of Internet commerce and ongoing issues over sales tax collections on these transactions could disproportionately impact sales-tax-reliant states such as Texas. Additionally, Texas' relatively high sales tax rate might potentially divert commerce to other states.

Then there is Medicaid. With the state opting out of Medicaid expansion under the Affordable Care Act (ACA), approximately 1.2 million Texans who would have received coverage under that program are unable to obtain it. However, it is also worth noting that Congress and the president explicitly excluded undocumented immigrants—a key group among the Texas uninsured—from ACA coverage.

Thus, states with high proportions of undocumented residents could expect to continue experiencing higher levels of uninsured regardless of the degree to which they embrace ACA (though the levels of the uninsured would obviously be lower with ACA than without). Moreover, Texas finds itself stymied by federal law in its efforts to make Medicaid more cost-effective, for example by implementing modest copayments to discourage casual use of Medicaid services. Efficiency measures like this would not reduce uninsured rates but could slow Medicaid cost growth and lessen state fiscal pressures.

Texas' population expansion is also an important issue. Realizing a population growth rate that exceeds the national average is, all things considered, a blessing rather than a curse. But it is unclear whether education funding will be sufficient to keep pace with future employer demands. Population growth can also strain other state services such as health care, transportation and infrastructure, and criminal justice. Failing to properly address these needs could result in a less productive workforce, which would slow the state's future growth rate.

Seldom pointed out in this context, however, is the role played by Texas' low-tax, lightly regulated business environment in helping the state annually grow about a percentage point faster than the nation over the last four decades. The challenge that state lawmakers will increasingly confront is how to address mounting health and education needs, possibly requiring additional revenue, without sacrificing the tax and regulatory attributes that have helped the state's economy consistently grow faster than the nation's.

Saving is a senior research economist and advisor in the Research Department at the Federal Reserve Bank of Dallas.

Notes

[1] The Texas Legislature convenes in January of each odd-numbered year to write a budget for the following two fiscal years. Thus, it will convene in January 2015 to write the 2016–17 budget.

[2] The Texas fiscal year begins on September 1, so the midpoint would be March 1.

[3] Because education funding is a joint state/local responsibility in Texas, it should be noted that local school property tax developments can still influence state tax allocation decisions.

[4] "Rankings and Estimates: Rankings of the States 2013 and Estimates of School Statistics 2014," by NEA Research, National Education Association, March 2014.

[5] Overall secondary education graduation rates in Texas remain very low relative to the national average.

[6] For more information, see "Texas Transportation Needs Summary," by the 2030 Committee of the Texas Transportation Commission, February 2009.

A Conversation with Joel Rodriguez

South Texas County Hopes to See Lasting Gains from Eagle Ford Shale Oil Boom

Joel Rodriguez took office in 2003 as La Salle County judge, the area's chief administrative and judicial officer. The South Texas county had among the largest oil production increases in the booming Eagle Ford Shale from 2010 to 2013. The Eagle Ford is one of the most productive formations brought online with hydraulic fracturing technology. As a result of the boom, wages and employment have soared, but so have rents and food prices.

Q. How has the oil boom changed life in your community?

The younger people are seeing opportunities here that they would never have seen. You have a number of families that have remained in these small communities that are very close-knit; it gives young workers an opportunity to provide for their families.

Your elderly population, your disabled have been hit hard because their income is only adjusted on a national basis, and it is not adjusted based on the increased costs that are due to local changes in supply and demand. Food, electricity, gasoline, labor, housing—all of it is higher.

On infrastructure, we have been pounded pretty hard. Let's look at traffic. In 2012, there were over 400 accidents with injuries, 52 percent of which were commercial-related, versus Dallas, Houston or San Antonio, with a 5 to 7 percent share.

We've also had to adjust from seven police officers to 22. Our volunteer fire department is being replaced by a full-time fire department.

Q. How fast did change occur?

Our tax base when I first came in [2003] was like $130 million, and then a few years ago [2008] it went up to $400 million, and then $800 million, then $2.6 billion, then $4.7 billion. I haven't seen the 2013 numbers. I'm curious.

I met with Chesapeake [Energy Corp.], and their properties' value was $1.6 billion in La Salle County alone.

Q. What is it like being the county judge in the midst of an oil boom?

Busy—it's very, very busy. You're spread out really thin. On New Year's Eve, I was working at home until 5 in the morning because I'm the type where in my mind I have to finish it. I've had a lot of those evenings where I work straight through.

We've had more appeals from Justice of the Peace court than ever before. I think the JP is getting 100 tickets a month. The restrictions on commercial driver's licenses are very strict, and they [drivers] can't afford the tickets on their driving records. So they appeal it to county court, and the county court is being overrun by appeals.

I'll have a docket call. It takes 25 to 30 percent of my time. There are other things. Probate cases have also really shot up. For many years, we would have people who would leave La Salle County and didn't value their land. They just left it, goodbye. With minerals, they're coming back and they want to probate their estates, figure out the minerals. The oil companies force them to do it.

Q. At what point did you realize that something was happening in La Salle County that would dramatically change life here?

In 2008, we had a road that was damaged by a company that was actually drilling in McMullen County [directly east of La Salle]. I really think that was the very first Eagle Ford well. Our attorney looked at the production numbers and said, "This is phenomenal." We were in mediation, and I remember him saying, "Just give us 1 percent of your production for a settlement." We ended up settling for $400,000 in damages. That's where we found out how serious the production was.

Q. Is La Salle County able to recoup the public costs of energy industry activity?

There's additional revenue coming—quite a bit of additional revenue—but as far as recovering the costs, no. Immediate recovery isn't going to happen.

The biggest concern about all your shale plays is that they have a shelf life, and when do the diminishing returns hit? We're hearing from the industry that in 15 years it will start to dwindle down. So we're trying to aggressively handle and construct as many projects before that curve starts going down. The biggest fear I have is that it's so hard to determine when it will go down.

If you don't issue debt for infra-

We are very active in the food bank. We are seeing more and more people participate because food is outrageous—$6 for a box of Froot Loops. Seriously.

structure, it may have some effects later on. You can't go on a pay-as-you-go basis because energy exploration has so much impact. In some places, you have 20,000 vehicles a day. If you have an overweight truck, then it has higher impact. They say one truck is equal to 1,200 vehicles. If you have 1,000 of them, that's 120,000 vehicles a day equivalent, and it just goes on. It's scary.

Our intention is to spend $100 million on county roads. We'll never have a chance to do this again. These roads and bridges are holding over from the Great Depression.

We're working on the parks; we've got the jail. What's needed? We still don't have a hospital here. It's always going to be an issue. [The nearest hospital is 15 miles away in Dilley in Frio County.] We're building three new fire stations and three community centers.

Q. Weekly wages on average are up more than 13 percent in La Salle County over the last couple of years. Are there problems filling jobs? Where do teachers and newcomers live?

We're seeing with some restaurant jobs that they're having a hard time retaining people because of a lack of long-term housing. There's plenty of RV housing, but it's really inflated.

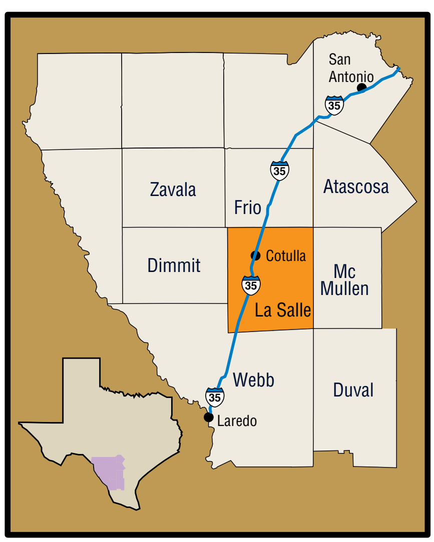
Teachers commute; they double up with other teachers. With our police officers, we have some FEMA [Federal Emergency Management Agency] trailers that they're living in.

Until we build the fire station, we have the emergency operations center, and it has some temporary quarters. The firemen are living there. There are three different shifts. They're working out of a temporary building. The issue was that the volunteer fire department was so beat that we needed to get some immediate help to respond.

The county population was about 7,000 in 2010 and now is 10,000 to 12,000, easy. The concern always remains: How much of that is transient—here during the week but they have a homestead somewhere else.

Q. Are the costs of some things getting too high for some people?

During the election I saw some people who were just eating wieners for supper. Good people, disabled people … too proud to ask, but they're having a really, really hard time. It was sad. We are very active in the food bank. We are seeing more and more people participate because food is outrageous—$6 for a box of Froot Loops. Seriously. It's an extremely high cost of living—$7 per pound of Oscar Mayer bacon.



Q. How many people are living in trailers and temporary housing?

I'd say 2,000 people. Also, you have the "man camps" that have trailers. Mostly, your oilfield sites already have headquarters and bunks, and they use a bunch of trailers. They don't even come into town anymore. They actually live on-site like a little community. That's where you run into the issues with public water supply and protecting the public. If they are hauling water, it has to be in potable, approved containers overseen by the Texas Commission on Environmental Quality.

Q. Is there a public health hazard?

Yes. Anytime you're dealing with water, you don't know what's been in the containers. You don't know if the water has been treated. If it's not a public source, you don't know what kind of contaminants may be in the water. In our case, there was an issue of coliform bacteria, stagnant water. It was nothing intentional. Anytime they set up a man camp, there is no guarantee that the water is going to be safe.

Q. Is there any way to be prepared for this?

No. We've all been reactive. We're good at being reactive and adjusting.

The hardest thing is that the communities have to get a belief: If communities feel that the shale play in Texas is going to be here for a while, they need to seriously invest in their infrastructure—whether it's new buildings, new schools, new roads—because they may not get another chance. You have to take advantage of it.

Hear additional excerpts of the interview at: www.dallasfed.org/research/swe/index.cfm.

CHILD MIGRATION: Crossings Surge as Smugglers Exploit U.S. Policy

More than 62,000 unaccompanied children were apprehended along the U.S.–Mexico border between October 2013 and July 2014, nearly 50,000 of them taken into custody in South Texas—representing a 148 percent increase over prior-year levels. By comparison, such apprehensions along the rest of the border increased 16 percent. Most of the children come from Honduras, Guatemala and El Salvador.

While economic conditions along with gang violence in the home countries have been cited as motivating the migration, government data indicate the Central American economies continue to expand at around 3 percent annually, the region's average since 2010. Additionally, while homicide rates are high, they have decreased in El Salvador and remained flat in Guatemala, while rising in Honduras.

Anecdotal reports suggest that smugglers have played a key role in the recent activity by promising parents that their children will be admitted into the U.S. and reunited with family members already here. Federal immigration policy dictates that children from noncontiguous countries be reunited with a family member in the U.S., if possible, while awaiting a court hearing, which can take years. Child migration is particularly profitable for smugglers because, while adults must evade detection to improve their chances of staying in the U.S., children need only to cross the border.

—Chelsea LeHew

ENERGY: Condensate Ruling Could Expand Eagle Ford Shale Exports

Two months after the U.S. Commerce Department allowed two Texas-based companies to export condensate, an ultralight oil, a tanker left Galveston for Asia in August, carrying the first shipment. The federal decision could clear the way for sale abroad of oil from South Texas' Eagle Ford Shale formation that could equal 25 to 50 percent of last year's total output. Nationwide, condensate made up approximately 12 percent of 2013 oil production.

With few exceptions, crude oil exports are banned under a 1975 federal law. The Commerce Department's Bureau of Industry and Security ruled that Irving-based Pioneer Natural Resources Co. and Enterprise Products Partners LP of Houston may export condensate.

Under the 1975 law, only exports of finished petroleum products, such as gasoline, diesel and jet fuel, are allowed. Officials defined condensate as a finished petroleum product because it is subject to some processing.

Following the decision, the price of benchmark West Texas Intermediate crude oil spiked to $107.25 per barrel—nearly $4 higher than the second-quarter average price—on anticipation that the export ban would be eased further. The price subsequently fell when officials indicated that existing policies will remain in place while the Commerce Department considers new industrywide guidelines.

—Kristin Shepard

BUSINESS CLIMATE: Texas Edges Out Florida for Survey's Top Spot

Texas has been named the best state for business in a survey conducted by *Chief Executive* magazine, a distinction it has held since the annual ranking began in 2004. Texas edged out No. 2 Florida. Texas graded well for job growth, taxation and regulation, and workforce quality—a measure of employee work ethic, workforce education attainment and labor costs. Florida advanced on the basis of quality of living environment.

The magazine's rating is based on responses from more than 500 chief executive officers, who are asked about their home state's business environment. Among states in the Eleventh District, Louisiana improved the most, jumping from 40th in 2009 to ninth in 2014, while New Mexico, after reducing its corporate income tax rate, advanced from 33rd in 2012 to 30th in 2014.

Although Texas remained first overall, it ranked ninth in terms of quality of living environment, a category that includes public education, public health, real estate costs and access to public transportation. According to the 2012 American Community Survey, 81 percent of Texans age 25 and older hold at least a high school degree, the lowest such share in the nation. Additionally, Texas has the highest percentage lacking health insurance, 23 percent.

—Sarah Bindner

Southwest Center Mall, Dallas

Cities Look to Regenerate Activity at Old Malls

By Michael Weiss

Sitting on 96 acres at the intersection of two freeways, Southwest Center Mall in Dallas was built in 1975 to serve a growing suburban clientele. Over time, merchants occupied nearby strip malls to pick off some of the traffic traveling to the shopping mall, which boasted five major anchors in 2000.

The mall today retains only two original anchors. The city of Dallas is working on a $72.3 million package to regenerate sales-tax-producing retail activity in and around the mall. It's the kind of effort playing out across Texas as cities commit funds to jump-start once-vibrant revenue sources that have morphed into enormous underutilized tracts.

Houston officials have fashioned a nearly $70 million plan to resuscitate the area around Greenspoint Mall, which lies along Interstate 45 and Sam Houston Parkway, not far from Bush Intercontinental Airport. City leaders in the Dallas suburb of Arlington have identified the Six Flags Mall area for redevelopment as part of its business plan to "build a thriving community." Owners of the mall, across a freeway from its namesake amusement park, seek to transform it using a Hispanic shopping theme.

The concept of the traditional, covered shopping mall, which epitomized retailing in the 1980s and 1990s, is stagnating. Since 2007, the number of regional malls with 1 million square feet or more of space has held constant at around 500, according to real estate researcher CoStar Group Inc. The Mall at University Town Center in Sarasota, Fla., scheduled for completion in October, will be the first traditional covered facility to open since 2006.

Retailers confront a changing landscape that accelerated with the recent financial crisis, prompting some mall stalwarts such as Plano-based J.C. Penney and Fort Worth-based RadioShack Corp. to review store count. Others have also sought to boost efficiency by reducing store size, in some cases moving to free-standing, nonmall units.

Internet sales figure in the change. E-commerce, which amounted to about 2 percent of U.S. retail sales in 2002, increased to 6 percent in 2013, according to Census Bureau data. E-commerce sales were $263.37 billion in 2013, while overall retail activity totaled $4.53 trillion.

Tax Collection Impact

Because state and local governments in Texas collect up to 8.25 percent in sales tax on brick-and-mortar retail sales, the movement of transactions to the Internet—where tax collection is hit and miss—is noteworthy. The retail sector generated approximately 28 percent of taxable sales in Dallas during 2010, according to data compiled by the city's chief financial officer. Each 1 million square feet of occupied retail space accounted for $800,000 in city revenue.[1]

Traditional retailing is a business of critical mass. Shoppers migrate to areas where they perceive that they have choices—in essence, the ability to search for several different kinds of items in one trip. There is also the expectation that a concentration of outlets and the accompanying competition lead to lower prices.

Salvaging a mall that's fallen on hard times involves changing retail momentum, making the task more involved than simply dealing with a huge covered space surrounded by acres of parking. Gaining consensus on a revival plan is often complicated by multiple-party ownership of malls. Once a mall appears faded, the perception of blight tends to drive away potential customers.

Windsor Park Mall, a 1.2-million-square-foot facility on 68 acres abutting northeast San Antonio, lost its last large retail tenant in 2005. Today, the space that Dillard's and Waldenbooks and more than 100 other stores occupied houses the headquarters of Rackspace Hosting Inc., a cloud computing company. Project supporters point to it as an example of redevelopment potential.

Private investors and a development corporation backed by the city of Windcrest purchased the mall for $27 million in April 2007. City-issued bonds financed a $100 million transformation from mall to technology office, and the Texas Enterprise Fund committed another $30.5 million if Rackspace met hiring targets statewide. While a shaky economy derailed the original goal of bringing 4,500 jobs to the former mall by Dec. 31, 2012, the company said it attained a revised benchmark of 1,774 jobs, with annual median pay of $51,000. The company also received a 14-year property tax exemption.

Meanwhile, land around Windsor Park has changed hands in anticipation of an influx of businesses serving a new clientele—Rackspace workers, who totaled about 3,000 at the start of the year.

Note

[1]Data from a city of Dallas memorandum to members of the budget, finance and audit committee by Jeanne Chipperfield, chief financial officer, Nov. 4, 2010.

Mexico's New Banking Measures Aim to Increase Credit, Transparency

By Edward C. Skelton

ABSTRACT: The overhaul of Mexico's banking laws, enacted as part of President Enrique Peña Nieto's wide-ranging economic and business structural changes, is designed to increase credit to small and medium-sized businesses while enhancing regulatory oversight and transparency.

Promises of wide-ranging structural reforms aimed at boosting long-run growth and economic development accompanied Mexican President Enrique Peña Nieto's arrival in office in December 2012.

Changes have followed, including legislative approval of plans to modernize important sectors of the economy, most notably a constitutional amendment ending state monopolies over oil and gas as well as electricity.[1] Other moves affect telecommunications and broadcasting, anti-monopoly rules and penalties, education, fiscal policy, and congressional and local elections. The overall economic package is forecast to add 1 to 2 percentage points to growth in the medium- to long-term.

A less heralded development, involving the banking system, could provide the biggest immediate economic boost. By making it easier for households and smaller enterprises to access credit, Peña Nieto's financial system overhaul seeks to bolster growth in the short run and foment broader economic development in the long run. The new law—"Ley para Regular las Agrupaciones Financieras"—has the potential to increase the productivity of small and medium-sized businesses and help workers borrow against their future income, improving social mobility and income distribution.[2]

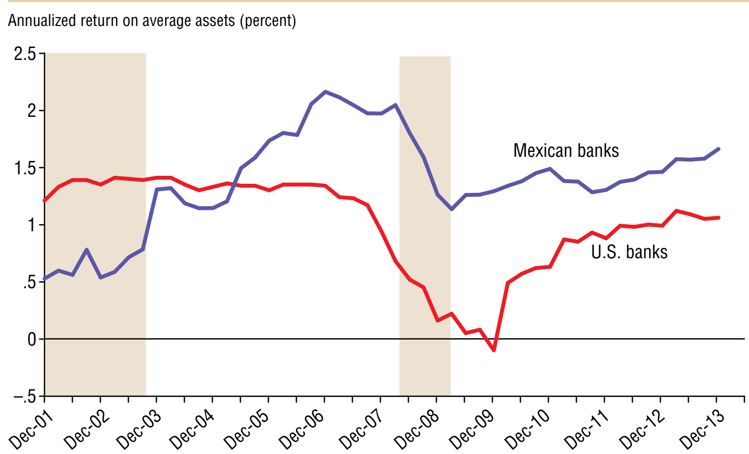
Increasing Competition

Mexico's banking industry is highly concentrated—its five largest banks hold 72 percent of system assets. Moreover, the country's banks have a reputation for high fees and interest rates, conservative credit policies and indifferent service.

The nation's central bank, Banco de México, in an effort to reduce commercial bank charges and commissions, publishes on its website the institutions' fees and interest rates and requires them to divulge the true cost of borrowing.[3]

Banks are very profitable, with consistent and strong earnings for more than 15 years (*Chart 1*). Banks managed to post a return of 1.1 percent of assets

Chart 1 Mexican Banks Post Strong, Consistent Profits



NOTE: Shaded areas denote Mexican recessions, as defined by the Instituto Nacional de Estadística y Geografía (INEGI).
SOURCES: Comisión Nacional Bancaria y de Valores; INEGI; Reports of Condition and Income.

in 2009 when real (inflation-adjusted) per capita gross domestic product (GDP) declined about 9 percent. By comparison, U.S. banks' losses totaled 0.1 percent of assets that year.

For its part, the Mexican Bankers Association rejected the argument that industry profitability is excessive, saying earnings are proportional to risk. Those returns have spawned recent market entrants, who have set up shop with the backing of government officials seeking to increase the number of commercial banks.[4]

Recent regulatory changes aim to increase bank competitiveness partly by explicitly prohibiting bundled sales of financial products. For example, it was common practice for banks to require consumers receiving an auto loan to purchase insurance from the same financial group or to require borrowers to also maintain a deposit account.

To further promote competition, customers will be able to more easily transfer accounts and loans to other institutions, allowing greater mobility of deposits and consumer loans. Prior to the change, borrowers could generally only refinance a loan with the existing holder of the credit. The new law allows subrogation, meaning that when the proceeds from a new loan are used to satisfy a prior lien, the new lender replaces the prior lienholder. Subrogation makes it much easier for borrowers to refinance mortgage loans with another lender.

Assessing Competitiveness

Mexico's newly autonomous and empowered antitrust commission (known by the Spanish acronym Cofece) turned its attention this year to the country's concentrated banking industry, with agency head Alejandra Palacios characterizing the sector a top priority.

In March, Cofece began preparing a study of the financial sector and drafted a series of recommendations to boost competition. The commission is expected to present the study to Congress in the third quarter. Cofece also has the power to open formal investigations of specific banks, which could lead to price regulation, forced asset sales and other actions. Under the new competition law (one of the structural changes), court challenges cannot delay commission actions (except forced asset sales).

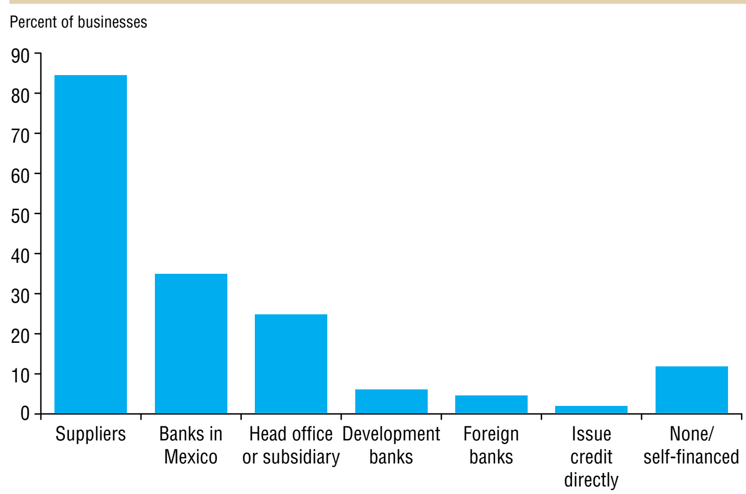
Smaller Business Credit Access

Arguably the banking system's greatest weakness involves small and medium-sized businesses' difficulty obtaining credit. Only 32 percent of all established "formal" businesses in Mexico have arranged financing via either a loan or line of credit, according to the World Bank's Enterprise Survey.[5] By comparison, a rate of 80 percent is prevalent in Chile and 66 percent in Brazil. For small and medium-sized businesses, the situation is worse—18 percent of formal businesses with fewer than 20 employees have access to regular financial channels in Mexico, compared with 73 percent in Chile and 43 percent in Brazil.

Instead, both large and small Mexican businesses rely on their suppliers for financing (*Chart 2*). A recent academic study found that when compared with similar firms without credit access, small and medium-sized businesses with the ability to obtain any type of formal financing were better able to grow and increase employment.[6] And, to the extent that access to credit helps firms grow, the economy as a whole realizes productivity gains, by absorbing workers from less productive enterprises, expanding the

> *Arguably the banking system's greatest weakness involves small and medium-sized businesses' difficulty obtaining credit.*

Chart 2 Mexican Businesses Rely on Suppliers for Financing



NOTE: Data add to more than 100 percent because some businesses have more than one source of credit.
SOURCE: Banco de México, *Evolución Trimestral del Financiamiento a las Empresas*, First Quarter 2014.

capital stock and achieving efficiency gains within individual firms.

Bolstering Regulatory Oversight

Mexico's financial overhaul should help regulators and improve consumer rights. Condusef, a consumer watchdog government agency, will be better able to increase transparency and punish potentially abusive practices. Significantly, Condusef will also be able to directly counsel and advise consumers on financial products and services. The new law also creates an independent arbitrator, housed within Condusef, to resolve customer complaints about financial institutions.

The initiative also establishes new oversight. The Bureau of Financial Entities (Buró de Entidades Financieras) will issue information on the practices of each financial institution, maintain a list of sanctions imposed and improve consumers' access to information.

The new measures also increase the authority of the Banking and Securities Commission (known by its Spanish acronym, CNBV). The regulator will publish the amount of fines and other punishment, including pending actions. In the past, authorities could not divulge bank sanctions until all appeals were exhausted, delaying disclosure sometimes by years.

Regulators are to periodically assess lending to ensure efficient credit flows and evaluate how well banks support the most productive sectors of the economy. The CNBV will have the authority to direct institutions to lend to specific sectors or industries, focusing on small and medium-sized businesses. It is unclear how this will work in practice. A regulator requesting a bank to increase its lending is unusual and gives rise to concerns that banks may face undue pressure or that credit could be misallocated.

Capital rules outlined in international banking reforms, known as Basel III, are included in the law as are new liquidity stress tests and contingency planning requirements.[7] Another legal change was tightening the liquidation process for insolvent banks and clarifying how banks are declared insolvent. Before the change, legal uncertainty surrounded the conditions under which insolvency could be declared and the mechanics behind bank liquidation, including payment to eligible depositors. Besides laying out a resolution process, the law establishes a process to determine if a failing institution is systemically important to the entire financial system. Institutions won't be designated systemically important until failure, and secondary legislation will be necessary to establish special resolution facilities for such banking operations.

Strengthening the Legal Regime

Banks should directly benefit from a strengthening of loan guarantees and the recovery of collateral as well as a streamlined bankruptcy process. Previously during bankruptcy, debtors used now-closed loopholes to prolong debt resolution. The law makes it easier during a liquidity crunch to obtain bridge lending—temporary financing until more permanent arrangements are in place.

The reform also allows banks to recover cash pledged as security on a credit without filing a formal lawsuit and receiving a judicial order. To implement these changes, the law creates a system of specialized courts and judges and also makes it easier to secure loans. The new system will shorten the period necessary to repossess collateral and enforce loan guarantees. In turn, the changes are expected to promote credit growth.

Development Bank Emergence

In addition to commercial banks, Mexico has six state-owned development banks (*see box*). Traditionally, the development banks have been risk averse. Under the new rules, they will have greater operational flexibility via an expanded mandate requiring them to promote economic development in their areas of specialization, explicitly financing small and medium-sized enterprises, infrastructure and innovation. Development banks will also be allowed to take on more risk, as long as core capital (typically equity and reserves) is not significantly affected.

Previously, the banks confronted restrictions on short- and medium-term loan issuance. There also were rules prohibiting more than one loan to the same borrower. The new rules allow loan guarantees for borrowers without finance ministry permission. Development banks may also lend based on

Mexico's Development Bank Specialization

Mexico's six development banks each specialize in a different area of the economy. Individual institutions seek to provide access to savings accounts, checking accounts and financing for individuals and businesses as well as provide technical assistance and training. The development banks and their areas of focus are shown below.

Development Bank	Specialization
Nacional Financiera (Nafin)	Small and medium-sized businesses
Banco Nacional de Obras y Servicios Públicos (Banobras)	Public infrastructure, especially municipal projects
Banco Nacional de Comercio Exterior (Bancomext)	Foreign trade for exporters and importers
Sociedad Hipotecaria Federal (SHF)	Housing, including housing development
Banco Nacional de Ahorro y Servicios Financieros (Bansefi)	Lower-income households and the unbanked
Banco Nacional del Ejercito, Fuerza Aérea y Armada (Banjercito)	The armed forces

pledged collateral, rather than only on a borrower's primary repayment capacity. By granting more credit, the development banks could play an important economic development role.

Mexico's commercial banks have expressed concern, citing the market distortions attributable to state backing of development banks. The commercial lenders argue that greater development bank activity would be helpful and complementary only if concentrated in indirect financing such as credit guarantees. Regulators, meanwhile, opined that the changes will allow development banks to better serve areas where the commercial banks do not operate.

Remaining Hurdles

Although the financial overhaul should help spread financial services and encourage economic development within Mexico, it does not address all the structural weaknesses impeding the development of the financial system. A high level of informality is the biggest issue.

Workers and businesses in the informal sector operate outside the regulatory umbrella and generally are unable to document their income or payment history. As a result, access to credit mostly occurs informally, such as from family or friends. Close to 60 percent of the country's workers are employed outside the formal sector, and informal economic activity totals approximately 30 percent of GDP, according to estimates by Mexico's National Institute of Statistics, Geography and Informatics.[8]

Recovering collateral is yet another impediment to credit access. On average, it takes commercial banks three years to repossess a house after its mortgage has become delinquent. In some cases, the process can run 10 years.

The new measures don't fully address the difficult collateral recovery process and require legislative approval of secondary laws that are expected to be introduced later this year. Plans include creation of specialized courts and judges.

While development banks will have more leeway to incur some losses, it remains to be seen if regulators and the Mexican Congress will tolerate shortfalls, which have traditionally been viewed as coming directly out of taxpayer pockets.

Last, authorities estimate 200 regulatory revisions will be required to implement the financial measures. Consequently, there is some risk that the spirit of the law may be lost in the process. And, although regulatory authorities will assess the banks' lending practices to ensure they are fulfilling their role as financial intermediaries, there are currently no objective standards to measure compliance.

Looking Ahead

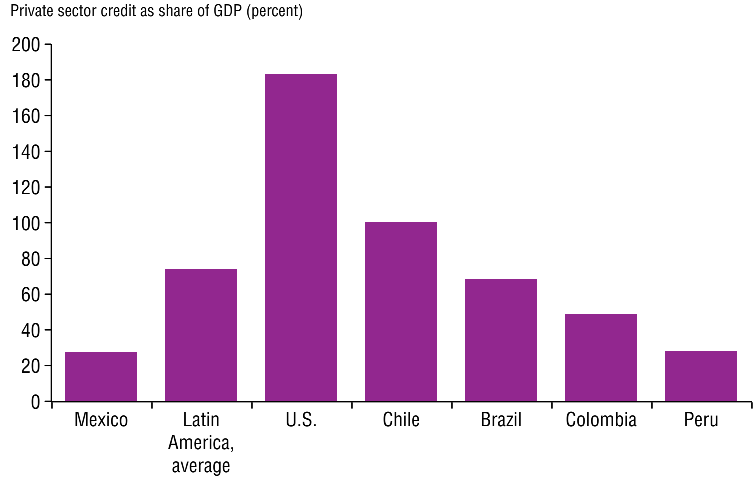
While transformation of Mexico's energy, telecommunications and fiscal laws have gained public attention, changes to the financial system could have the most direct effect on small and medium-sized businesses. Domestic lending to the private sector is expected to grow to as much as 40 percent of GDP by 2018, from about 25 percent in 2012 (*Chart 3*).

Mexico's Finance Ministry forecasts the new measures will boost annual growth by 0.5 percentage points between 2015 and 2018, mostly through increasing consumption and investment. To the extent that financ-

(Continued on back page)

Mexico's Finance Ministry forecasts the new measures will boost annual growth by 0.5 percentage points between 2015 and 2018, mostly through increasing consumption and investment.

Chart 3 Private Sector's Access to Credit Low in Mexico



SOURCE: World Bank, survey data as of 2012.

Federal Reserve Bank of Dallas
P.O. Box 655906
Dallas, TX 75265-5906

Mexico's New Banking Measures Aim to Increase Credit, Transparency

(Continued from page 15)

ing is more available to households and smaller businesses, informality could decline, improving efficiency and broadening economic development. Still, overall benefits will be determined by whether the new rules work as designed.

The financial sector is anticipated to function as a more effective development tool. The goal is to establish a virtuous cycle allowing more Mexicans to acquire the necessary resources to make their business plans a reality and establish productive enterprises in the formal market, creating quality jobs and sustainable future growth.

Skelton is a business economist in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Notes

[1] For more information about the energy reform, see "Reforma Energética: Mexico Takes First Steps to Overhaul Oil Industry," by Michael D. Plante and Jesus Cañas, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter 2014.

[2] The published law can be found at www.diputados.gob.mx/LeyesBiblio/pdf/LRAF.pdf.

[3] Banks must reveal the true cost of financing through the Costo Anual Total (CAT), which is equivalent to the annual percentage rate used in the U.S. More information is available (in Spanish) at www.bancodemexico.gob.mx/waCalculadoraTarjetaCredito/MasInformacion.jsp.

[4] For more information, see "Mexico Develops Niche Approach to Expansion of Banking Services," by Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter 2013.

[5] The survey of 1,480 Mexican firms was conducted between August 2009 and June 2010.

[6] See "Access to Credit and the Dynamics of Informality in Mexico," by Oscar Sanchez, Inter-American Conference on Social Security, Working Paper no. 0114.

[7] For more information about Mexico's adoption of Basel III capital standards, see "Mexican Banks Get Ahead of New Global Capital Standards," by Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter 2012.

[8] Among other benefits, the fiscal reform passed in October 2013 was designed to reduce the size of the informal economy. For more information about informality in Mexico, see "Informality in Mexico," by Nicola Brandt, Organization for Economic Cooperation and Development, OECD Economics Department Working Paper no. 896, October 2011. Informality varies by geographic region, and regional differences in formality help explain disparities in economic growth and development. See "The Determinants of Informality in Mexico's States," by Sean M. Dougherty and Octavio Escobar, Organization for Economic Cooperation and Development, OECD Economics Department Working Paper no. 1043, April 2013.

DALLASFED

Southwest Economy
is published quarterly by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Articles may be reprinted on the condition that the source is credited and a copy is provided to the Research Department of the Federal Reserve Bank of Dallas.

Southwest Economy is available on the Dallas Fed website, www.dallasfed.org.

Federal Reserve Bank of Dallas
2200 N. Pearl St., Dallas, TX 75201

100 YEARS™
FEDERAL RESERVE SYSTEM