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THE TEXAS ECONOMIC MODEL: HARD FOR OTHER STATES TO FOLLOW AND NOT ALL IT SEEMS

By Elizabeth McNichol and Nicholas Johnson

Whatever its boosters may say, Texas is not a helpful model for economic growth for the rest of the country. True, the number of people and jobs in Texas has been expanding, causing other states to wonder whether Texas holds important lessons for state policies that can generate similar growth elsewhere. The answer is no.

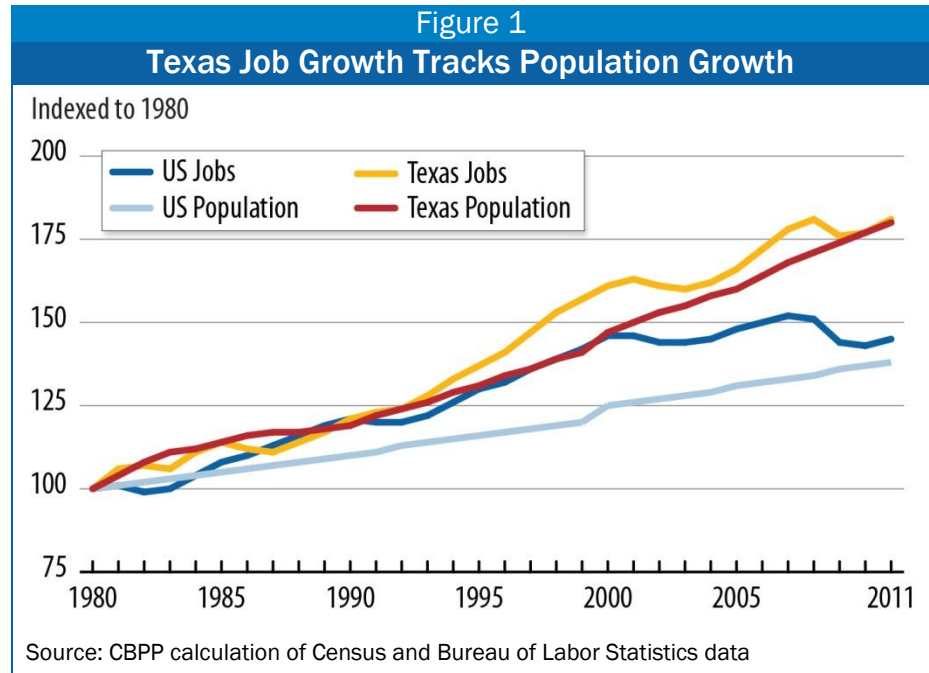
- Texas has unique geographic and demographic characteristics that have helped lift its economy in recent years. Its border location encourages trade and immigration and helps fuel population and job growth.
- A combination of available land and lending regulations have kept housing prices comparatively low and helped Texas avoid the real estate depression that dragged down many other state economies.
- Though Texas' economy has diversified in recent decades, the state's abundant oil and gas resources remain a valuable asset — especially when prices for those commodities are high — that most other states lack.
- Even if it were possible for other states to replicate these features, the fact that so many Texans have failed to benefit from them — with poverty, low-wage jobs and lack of health insurance all above the national average — makes Texas a less-than-desirable model to follow.

The Texas growth narrative is well-known by now. Texas' population grew by 11 million people (79 percent) between 1980 and 2011, more than double the rate of growth of the nation as a whole. (See figure 1.) With that population growth came job growth. Since the 1990s, the rate of Texas job growth has been a full percentage point or more above the national average most years.

The American Legislative Exchange Council, among others, has suggested that other states should adopt policies that will make them more like Texas in order to grow their economies. One example from the introduction to ALEC's recent *Rich States, Poor States* report: “[M]any governors are

looking at Texas, which has led the nation in job growth over the past three years, as the state with the best policy to emulate.”¹ In particular, ALEC notes the state’s tax policy as a plus.

But if those governors look closely, they won’t find much they can emulate. The reality is that much of Texas’ growth results not from its policies but rather from factors that state officials cannot control. For example, Texas has been benefiting from cheap and plentiful land, a location that enables international immigration and trade, abundant natural resources such as oil and gas, and other advantages that cannot be exported.



Even with all those natural advantages, Texas’ economic picture is not entirely rosy, and it may not be able to retain the advantage it currently holds over other states for much longer. Beyond population and job growth, Texas continues to lag behind the rest of the country in other important measures of economic success. About one in ten hourly wage jobs in Texas pays at or below the minimum wage (\$7.25 per hour), more than in any other state, and Texas has the nation’s 11th-highest poverty rate. Such high levels of poverty and low-wage employment make the Texas economy a dubious model for the nation.

Texas Job Growth Is Due to Factors That Other States Cannot Replicate

Opponents of progressive taxation have asserted that features of Texas’ tax system — such as the absence of an income tax — drive the state’s economic growth. But this is highly unlikely. Econometric studies find that the effect of state taxes on economic growth is typically quite small, and often depends on holding expenditures on public services constant — which rarely is possible in the real world, as budgets must be balanced and as state expenditures on education, infrastructure, highways, and public health matter at least as much as taxes in determining economic growth rates.²

¹ Arthur Laffer, Steven Moore, and Jonathan Williams, *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index*, American Legislative Exchange Commission, 2011, http://www.alec.org/docs/RSPS_4th_Edition.pdf p. 30.

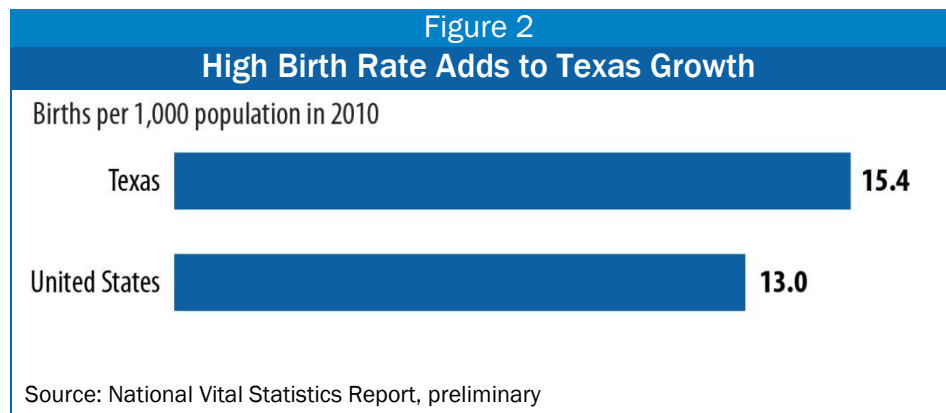
² To give one recent example of a study that found no effect of income taxes on economic growth at all, see James Alm and Janet Rogers, “Do State Fiscal Policies Affect State Economic Growth?” *Public Finance Review*, July 2011. Even setting aside the offsetting impact on public services, a comparison of the research literature with what has actually happened in Texas suggests that the tax effect on the state’s economic growth is far too small to be a major driver of the Texas economy. For instance, in a major 1991 review of the academic literature, Timothy J. Bartik estimated that a 10

As discussed later in this paper, Texas spends less in those areas than other states, largely because it has less tax revenue to spend. Thus, whatever benefits Texas may be acquiring by virtue of having lower taxes likely have been wiped out by its lower expenditures on services.

Moreover, there are other explanations for Texas' growth more plausible than taxation. Research papers that focus broadly on explaining the Texas economy³ point to four factors that have driven the growth of Texas jobs since the late 1980s and that have little or nothing to do with taxes. These four factors are high rates of international immigration and population growth; high oil and gas prices; low housing costs and population density; and Texas' prime location along the Mexican border.

Population Growth and Immigration

Texas' rapid population growth has been a major driver of the state's economic growth over the last several decades. While some boosters claim that the population growth has resulted from public policies that lure migrants from other states, in fact the vast majority of the state's growth is the result of two factors specific to Texas: The state's relatively high level of "natural growth," i.e. births minus deaths; and international immigration, much of it from neighboring Mexico.



Specifically, Texas has the nation's second-highest birth rate (after Utah),⁴ which researchers attribute to a variety of demographic, socio-economic, and cultural factors.⁵ Texas is also a major entrance point for immigration from Mexico and Central America to the United States.

percent business tax differential between two jurisdictions might produce, over a long period of time, a 2.5 percent difference in economic growth. See *Who Benefits from State and Local Economic Development Policies?*, Upjohn Institute, 1991. Had Texas merely outgrown the national average by 2.5 percent over 25 years (i.e. just 0.1 percent per year), it would not be promoted as a model for growth.

³ Two helpful overviews are *The Face of Texas*, Federal Reserve Bank of Dallas, October 2005, and "Texas in Focus: A Statewide View of Opportunities," issued by Susan Combs, Texas Comptroller of Public Accounts, January 2008.

⁴ Kaiser Family Foundation, statehealthfacts.org, D'Ann Peterson and Laila Asamie, "The Face of Texas," Federal Reserve Bank of Dallas, October 2005, p. 38.

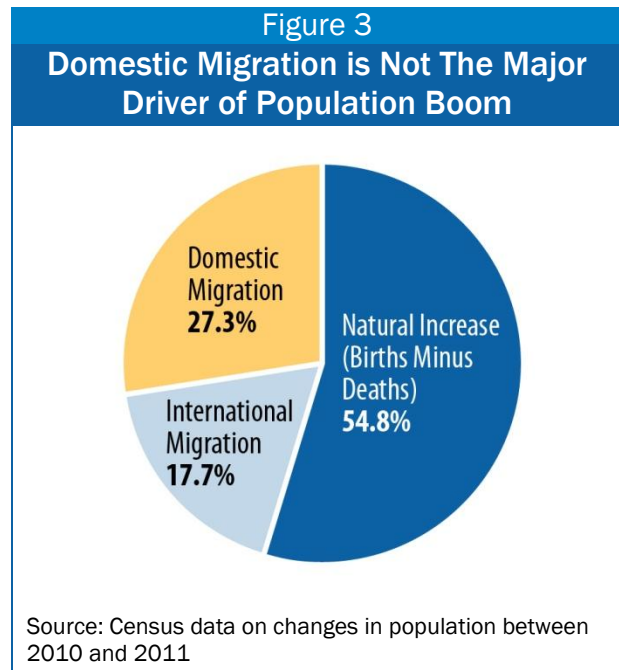
⁵ The birth rate in Mexico is consistently higher than that of the United States, and birth rates are higher for Mexicans and Central Americans who move to Texas than for other demographic groups, partly because of their lower average income and education levels (in general, wealthier and more educated women tend to have fewer children and because of cultural and religious factors).

International immigration provides Texas a steady base of population growth. Between 2000 and 2009, more than half of the net migration to Texas was from Mexico and other countries.⁶

Most recently, about 72 percent of Texas' net population growth last year resulted from international migration and natural growth, according to the Census Bureau; the remaining 27 percent resulted from net domestic migration.⁷

This population growth in turn has caused job growth. Population growth has fueled demand for housing, goods, and services such as education. This increased demand has spurred expansion of businesses, schools, and so on, creating jobs in both the private and public sectors.

The nature of Texas' population growth also provides a buffer against economic downturns. "Although domestic in-migration — people moving to Texas from other states within the United States — slowed during Texas' hard economic times, the state's high birthrate and a strong pace of immigration kept population growing at a healthy speed," the Federal Reserve Bank of Dallas noted in a 2005 publication.⁸ Other states that are not so close to Mexico and that have lower birth rates cannot easily replicate the population growth of Texas.



Low Cost of Living and Low Housing Prices

A second major contributor to Texas growth is that the cost of living is considerably lower than the national average. Housing, which represents roughly one-third of a typical household's spending, is particularly inexpensive.⁹

Texas has the second-biggest land area in the country, much of it quite flat and thus available for development. The supply of land keeps prices low and makes it considerably less expensive to start a business or build housing than in many other parts of the country. Texas has by far the most open land among the nation's most populous states. The population density of Texas is less than half of

⁶ Office of the State Demographer, "Texas Demographic Characteristics and Trends," presentation, February 3, 2012; and U.S. Census Bureau, *Components of Population Change*.

⁷ CBPP calculations of Census data from <http://www.census.gov/popest/data/state/totals/2011/tables/NST-EST2011-05.xls>.

⁸ D'Ann Peterson and Laila Asamie, "The Face of Texas," Federal Reserve Bank of Dallas, October 2005, p 38.

⁹ Bureau of Labor Statistics News Release, Consumer Expenditure – 2010, September, 2011. The Consumer Expenditure Survey also shows that housing prices vary more by region than the next largest expenditure, transportation.

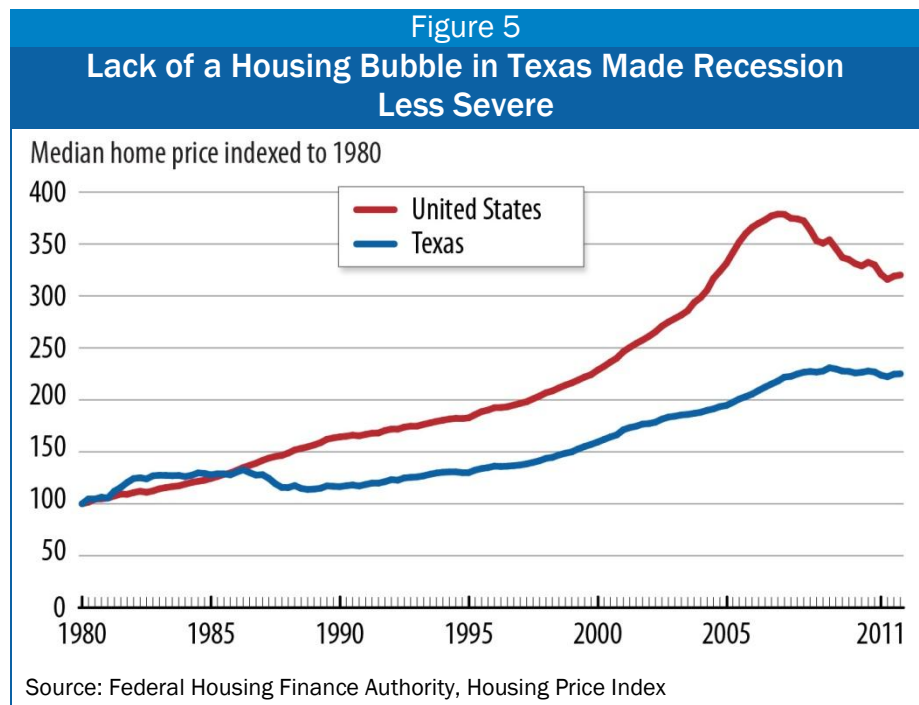
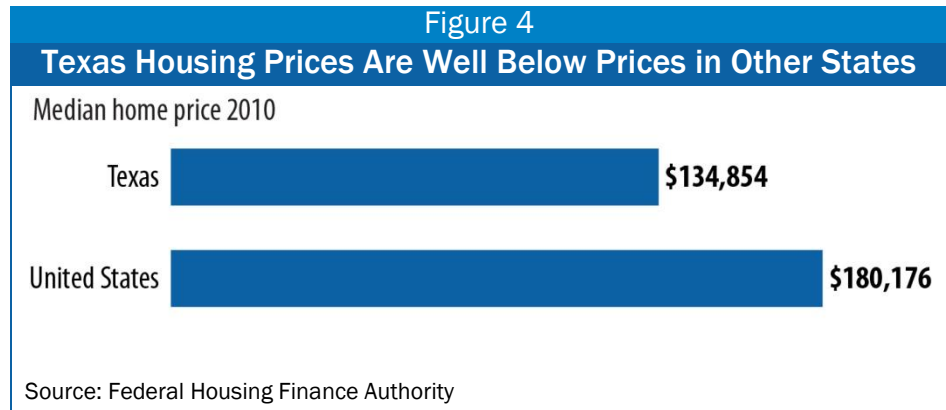
that of California, less than one-fourth of New York's or Florida's, and about one-third of Pennsylvania's, and (as discussed further below) has only recently crept above the national average.¹⁰

The supply of land helps explain the cheap housing. Between 1960 and 2000, the median house price in Texas was 70 percent to 80 percent of the national figure. During the mid-2000s when housing prices rose dramatically in most of the rest of

country, this differential widened. By 2005, the median price of a home in Texas was below 60 percent of the national average.¹¹ Once the U.S. housing price bubble burst, national prices moved down closer to those in Texas, and the median price in Texas (\$135,000) is now about 75 percent of the national figure (\$180,000).

There is some debate about why housing prices did not soar in Texas along with the rest of the country. Whether it was because Texas was the last state to allow homeowners to borrow against their homes through equity loans and placed strict controls on the amount they could borrow, or whether it was the plentiful land or some other reason, there is no doubt that Texas did not face the boom and bust in housing that preceded the 2007-2009 recession in many states.¹²

In addition to keeping housing prices low, the absence of a housing price bubble (and subsequent implosion) benefitted the Texas economy in other ways. The mortgage foreclosure rate soared in other states but has been much lower in Texas. The Texas foreclosure



¹⁰ U.S. Census Bureau 2010 Census.

¹¹ Estimated Mean and Median House Prices for U.S. and States by Quarter, 2000 Q1 – 2010 Q2, Federal Housing Finance Agency.

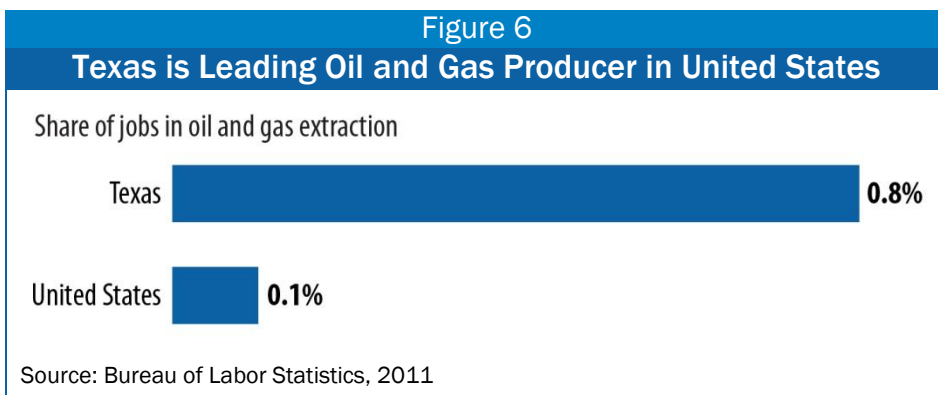
¹² Annie Lowry, "Texas Miracle: Can Other States Replicate Texas' Economic Success?" *Slate Magazine*, August 19, 2011.

rate was one in every 1,044 mortgages in February 2012, just 60 percent of the national rate and less than one-third the rates in Nevada, California, Arizona and Florida.¹³ As a result, as other states' residents lost their homes and savings, with damaging effects on local economies, Texas has not faced the same economic fallout.

Oil and Gas

For much of the 20th century, Texas' economic performance was driven largely by changes in oil prices. Since the mid-1980's, the state's economy has diversified considerably. But energy is still very important. Texas remains the nation's largest producer and refiner of oil and gas.¹⁴ Higher oil prices and the rapid expansion of gas production from shale formations continue to boost the state's economic growth.

To be sure, there have been ups and downs; but in general, data compiled by the Federal Reserve Bank of Dallas shows that the oil and gas industry has been a major driver of growth. In the 1970s and 1980s, when



oil prices were rising rapidly, Texas' economy boomed. In 1981, oil and gas production represented almost 20 percent of Texas's total economic output. The oil price collapse of 1986 resulted in a statewide recession and significant job losses. Other sectors of the Texas economy took advantage of the oil bust and the economy diversified; by the late 1990s, oil and gas extraction was just 4 percent of economic output in Texas. The following decade brought higher oil prices and a resurgence of the industry. By 2008 oil and gas production had rebounded and oil and gas extraction alone accounted for 11 percent of Texas' economy.¹⁵

What this means is that an increase in oil prices still makes a big difference in the Texas economy. A 2005 study by the Federal Reserve Board of Dallas found that "the Texas economy has become less sensitive to oil price fluctuations, but it still responds favorably to higher energy prices."¹⁶ When oil prices rise, it increases the value of the oil and gas coming out of the ground in Texas. It also leads to higher profits for Texas oil companies, and creates a strong incentive for them to hire more workers and buy more equipment to produce even more oil and gas. The Dallas Fed reports that from 1997 to 2010, each 10 percent increase in oil prices has resulted in a 0.5 percent increase in

¹³ From REALTYTRAC, www.realtytrac.com/trendcenter/trend.html.

¹⁴ Susan Combs, Energy Report, website of Texas Comptroller, downloaded on March 28, 2012 from www.susancombs.com/print/82.

¹⁵ The Southwest Economy First Quarter 2011, Federal Reserve Bank of Dallas, p 34.

¹⁶ Stephen P.A. Brown and Mike Yücel, "Do Higher Oil Prices Still Benefit Texas?" *The Face of Texas*, Federal Reserve Bank of Dallas, October 2005, p 36.

Texas' GDP and a 0.36 percent increase in employment.¹⁷ The energy sector has also benefited tremendously from the recent development of the Barnett and Eagle Ford shale deposits of oil and natural gas.

Of course, Texas is not the only state to benefit from high energy prices and newly available oil and gas sources. High oil prices at the start of the 2007-09 recession helped insulate Texas and other mineral-rich states — such as Montana, North Dakota and New Mexico — from the full force of the economic downturn. Unemployment has remained below the national average in these states as in Texas, and they faced relatively small or no budget shortfalls in 2009.

Mexico

The fourth major factor contributing to the state's population and job growth has been Texas' proximity to Mexico. As noted above, it has resulted in international immigration being one of the main drivers of the state's population growth. In addition, Texas border cities get an economic boost from factories in Mexico — known as maquiladoras — that work closely with U.S. counterparts.

Here's how Federal Reserve Bank of Dallas researchers have described the typical economic impacts of any new maquiladora on a nearby U.S. city:

“To select and develop a site, U.S. legal, engineering and financial assistance would be used. Once established, the new plant would rely on U.S.-based businesses for customs, brokerage, warehousing and transportation services. The plant would also purchase a variety of office, packaging and industrial supplies. Corporate management, engineers and quality specialists would be drawn to the border to visit this plant, and they would spend money on food and lodging. Maquiladora employees draw their salary in Mexico but do a significant share of their shopping in the United States, stimulating employment in local retail and service sectors.”¹⁸

United States trade with Mexico grew significantly in the 1980s, slowed some during the early 1990s, and then boomed again in the mid-1990s, after passage of the North American Free Trade Agreement (NAFTA). At the same time, the collapse of the peso made importing from Mexico more profitable. As factories expanded in Mexico, Texas' economy got a big boost. A 10 percent increase in Mexican export manufacturing leads to a 1 percent to 2 percent increase in employment in U.S. border cities, University of Texas Professor Gordon Hanson found.¹⁹

Retail businesses in Texas near the border also benefit from the increased jobs and economic activity that NAFTA has brought to Mexico. Mexican employees of the maquiladoras cross the border to do a significant share of their regular shopping in stores in Texas border cities. “The large

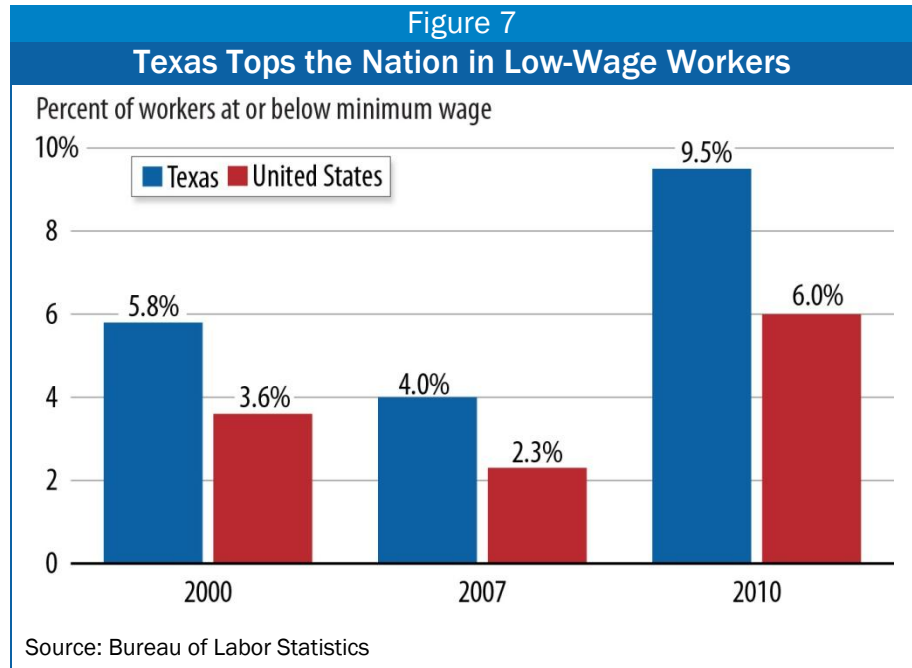
¹⁷ Mine K. Yücel and Jackson Thies, “Oil and Gas Rises Again in a Diversified Texas,” *The Southwest Economy First Quarter 2011*, Federal Reserve Bank of Dallas, Table 1.

¹⁸ Jesus Canas, Roberto Coronado and Robert W. Gilmer, “Texas Border, Employment and Maquiladora Growth,” *The Face of Texas*, Federal Reserve Bank of Dallas, October 2005, p. 28.

¹⁹ Gordon H. Hanson, “U.S.-Mexico Integration and Regional Economies: Evidence from Border-City Pairs”, *Journal of Urban Economics*, 2001.

and growing population on the Mexican side of the border represents an important consumer base for retail stores in U.S. border towns,”²⁰ the Federal Reserve Bank of Dallas noted in a 2005 study.

Mexican shoppers accounted for \$2 billion in retail sales in Texas in 2001, the study estimated. While that represents a relatively small share of total retail sales in the state, it provides a major boost to the economies of border cities, accounting for 11 percent to over 50 percent of retail sales.²¹ The amount of retail sales to residents of Mexico is affected by the value of the peso and competition with Mexican stores. The retail industry in Mexico has been expanding putting downward pressure on sales in Texas border cities.

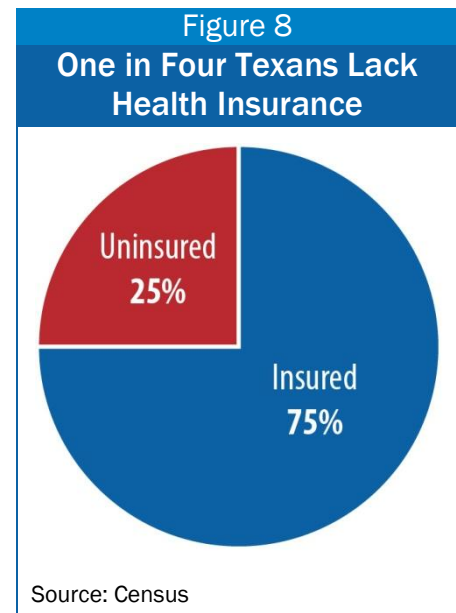


The Quality of Jobs and Quality of Life in Texas: All Is Not Rosy

Even if it were achievable for other states to make their economies more like that of Texas, they might not want to. Despite the state’s overall economic growth as measured by the change in the number of jobs and overall economic output, many Texas jobs still pay lower wages and offer fewer benefits than in other states, resulting in continued high levels of poverty and inequality. And the state offers fewer public services to its residents.

For instance:

- Texas has the highest share of minimum-wage workers of any state. In 2011, 9.5 percent of Texas hourly workers were paid at or below the minimum wage. This is well above the US average of 6.0 percent and the highest proportion of any state.

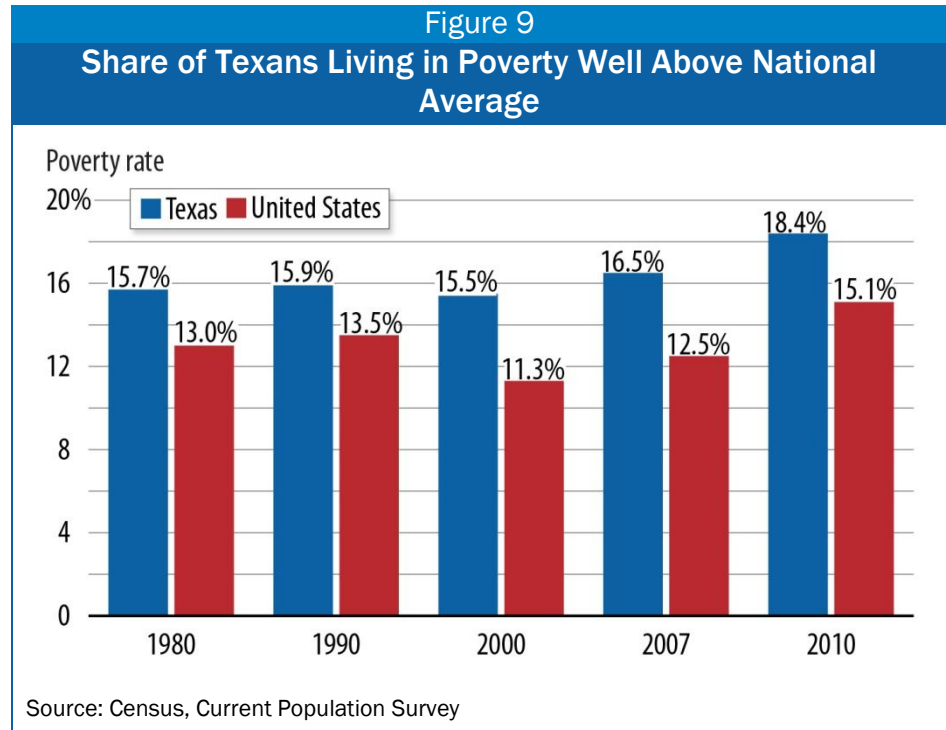


²⁰ Keith R. Phillips and Roberto Coronado, “Texas Border Benefits from Retail Sales to Mexican Nationals”, *The Face of Texas*, Federal Reserve Bank of Dallas, October 2005, p. 24.

²¹ Ibid, p. 25

One-quarter of people in Texas lack health insurance — well above the national average of 16.3 percent, according to the most recent data from the Census Bureau. Many Texas employers do not provide health insurance for workers.¹ Just over half of the state’s non-elderly residents have employer-provided health insurance – the third-worst rate among the states. And Texas’ Medicaid program fails to cover many who cannot afford to pay for health insurance on their own.

- In part because wages are low, a large share of Texans are poor. In 2010, some 18.4 percent of Texas families lived in poverty. That is well above the



national poverty rate of 15.1 percent, and the 11th-highest poverty rate in the nation. Nor has the state’s growth reduced its poverty rate over the last three decades.

- Texas invests less than most states in education, healthcare, infrastructure and other public services important to the quality of life for a state’s residents, and the quality of those services has suffered as a result. Last year, for instance, Texas ranked 40th of the states in per pupil education spending. This level of investment persists even though Texas ranks second-to-last among the states in the share of its population with a high school diploma. Higher education is becoming less affordable as state support is cut. In-state tuition doubled at public universities in the state since 2003.²² Texas spends less on health care, per person, than all but nine states, and there are fewer doctors per person in Texas than in all but eight states. In addition, Texas ranked 40th on spending on highways.

Texas’ Advantage May Shrink as Recession Recedes

The potential appeal of the “Texas model” and its applicability to other states are further weakened by the fact that the magnitude of Texas’ recent growth relative to other states may turn out to have been somewhat of an aberration. For one thing, the natural advantages that Texas holds compared to other states insulated it somewhat from the effects of the last recession, at least until

²² Texas Higher Education Coordinating Board, Tuition and Fees Data, March 26, 2012. Available at <http://www.theccb.state.tx.us/reports/PDF/2460.PDF?CFID=27178926&CFTOKEN=22672367>.

recently. For the past five years, most other states have suffered from declining revenues caused by the recession while coping with the fallout from the bursting of the housing bubble. High oil prices were another strain on their budgets. Texas, on the other hand, did not face the housing price decline, and while other states have suffered from high oil prices Texas benefited. These factors magnified the perceived “Texas advantage” in the eyes of other states.

Now, the economic tide has turned in most states and they are growing. The impact of the housing bubble’s burst will begin to fade; natural gas prices have fallen to a ten-year low and oil prices may eventually stabilize.

Moreover, some of Texas’ other advantages may start to fade soon.

Texas’ rapidly growing population is (not surprisingly) making it more crowded. In 1980, Texas ranked 32nd in people per square mile, and its density was 15 percent below the national average. By 2010, the population density of Texas exceeded the national average by some 10 percent. One of the consequences of this population growth is an increasing demand for water. The Texas Water Development Board projects the demand for water will increase by 22 percent over the next 50 years. Existing water supplies, however, will drop by 10 percent. Meeting this demand will raise the costs of development or constrain future growth.²³

Meanwhile, housing prices in the rest of the country have declined significantly as a result of the bursting of the housing price bubble. Because Texas did not face a bubble, its home prices have remained steadier. (See figure.) Increasing density in Texas and declining prices elsewhere are gradually eroding the housing price advantage that Texas has held ever since the mid-1980s. In 2006, at the height of the housing price bubble, the median house price in Texas was only 57 percent of the national average. By 2010 it had climbed back to 75 percent as prices declined elsewhere. To be sure, Texas retains a housing price advantage, but as the magnitude of the advantage declines, so will the incentive for people to move there.

Another advantage that may lessen somewhat is the economic activity generated from Texas’ proximity to Mexico. New low-wage alternatives such as China, India and Vietnam have emerged as significant competitors to Mexico for the low-cost outsourcing of U.S. manufacturing. In addition, exports from Texas industries to Mexican counterparts have been declining. One reason is that Asia is beginning to replace the United States as a source for component parts and other inputs to Mexican maquiladoras. In 2000, 90 percent of inputs were from the U.S., and only 9 percent came from Asia. By 2004, 59 percent came from the US and 35.7 percent came from Asia.²⁴ If growth in the Mexican border industries slows or declines, the economies of Texas border cities will suffer. At the same time, there is concern that growth in cross-border shopping by Mexican residents will slow as more retail centers are developed within Mexico and security concerns make border-crossing more difficult.²⁵

²³ Texas Water Development Board, *Water for Texas 2012 State Water Plan*, January 2012.

²⁴ Jesus Canas, Roberto Coronado and Robert W. Gilmer, “Texas Border, Employment and Maquiladora Growth,” *The Face of Texas*, Federal Reserve Bank of Dallas, October 2005, p. 31.

²⁵ Jesus Canas, Roberto Coronado and Keith Phillips, *Border Benefits from Mexican Shoppers*, Federal Reserve Bank of Dallas, Southwest Economy, May/June 2006, p. 13.

Finally, as noted above, Texas invests less than other states in its infrastructure and in educating its workforce. This, too, could cause problems for the Texas economy in the future.

Conclusion

Other states should think twice before they make major changes in their tax and budget policies in an effort to generate the growth that Texas has seen in recent years. This growth is a result of the interaction of a host of factors that cannot be replicated by other states, and perhaps should not be replicated even if they can be. In addition, there are many reasons to believe that Texas' economy will not continue to shine so brightly relative to other states.