THE TEXAS ECONOMY

O'NEIL CENTER FOR GLOBAL MARKETS AND FREEDOM ★ SMU COX SCHOOL OF BUSINESS ★ MARCH 2016

Unlike the 1980s, Texas Keeps Growing with Oil Prices Low

By W. Michael Cox and Richard Alm

While much of the rest of the United States struggled, the Texas economy bounced back smartly from the financial crisis and recession of 2008-09. The state added more than 1.5 million jobs from 2009 to 2014—about half of the nation's total employment gains in the period.

The Texas economy was humming along nicely in 2014—then falling oil prices put the good times in jeopardy. The benchmark West Texas Intermediate (WTI) price dropped below $100 a barrel in late July, then continued to spiral through $90 in October, $80 and then $70 in November, $60 in December, $50 in January 2015, and $40 by year's end. WTI hit a low point just below $30 a barrel in February 2016. It rebounded to $40 by mid-March, but the overall slide exceeded 60 percent.

Remembering Texas' history, many feared the worst—for good reason. In the mid-1980s, a sharp plunge in oil prices sent the Texas economy into a tailspin, with many a fortune lost. As the oil money ran dry, real estate values plummeted, and just about all the big Texas banks went belly up.

Texas fell into a steep recession at a time when the overall U.S. economy was shifting toward higher growth. State GDP fell 3 percent in 1985-86, accompanied by a decline of 252,000 jobs, or 3.8 percent, between November 1985 and January 1987.

In percentage terms, the current oil-price collapse has been larger than the one in the mid-1980s—but outcomes for the Texas economy have been starkly different. As expected, oil-industry activity and employment have declined as crude prices fell over the past 20 months. The overall economy, however, has continued to grow, adding 428,100 jobs.

The Texas economy shrugged it off and bounced back, growing at an average annual rate of more than 4 percent from 1986 to 2005.

The job figures highlight a momentous change in the Texas economy. In the eight decades after that fateful gusher at Spindletop in 1901, Texas was driven largely by the oil business—for good and ill. What's different now is that the state keeps moving forward *without* the boost from high oil prices.

History doesn't repeat itself

Inflation-adjusted oil prices have been volatile over the past four decades, notably soaring in 1979-80 and 2007-08 and plunging in 1985-86, 2008-09 and 2014-15 (*see chart below, black line*). Texas' inflation-adjusted state GDP growth, the broadest measure of the state economy's performance, clearly shows the oil bust's heavy toll in the mid-1980s (*see chart below, red bars*).

It wasn't an oil price rebound that pulled Texas out of recession in the mid-1980s. In fact, oil remained cheap for the next two decades. No matter, the Texas economy shrugged it off and bounced back, growing at an average annual rate of more than 4 percent from 1986 to 2005. An economy that had been devastated by an oil-price collapse quickly and efficiently remade itself, gaining strength from the expansion of non-oil industries.

Today, Texas' non-energy economy is 14.2 times larger than it was in 1948.

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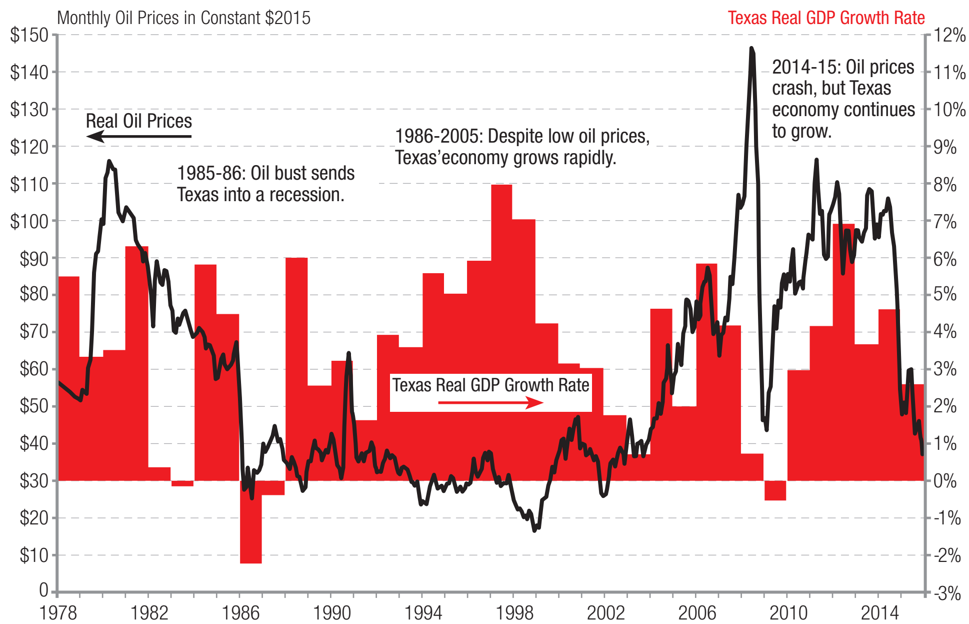
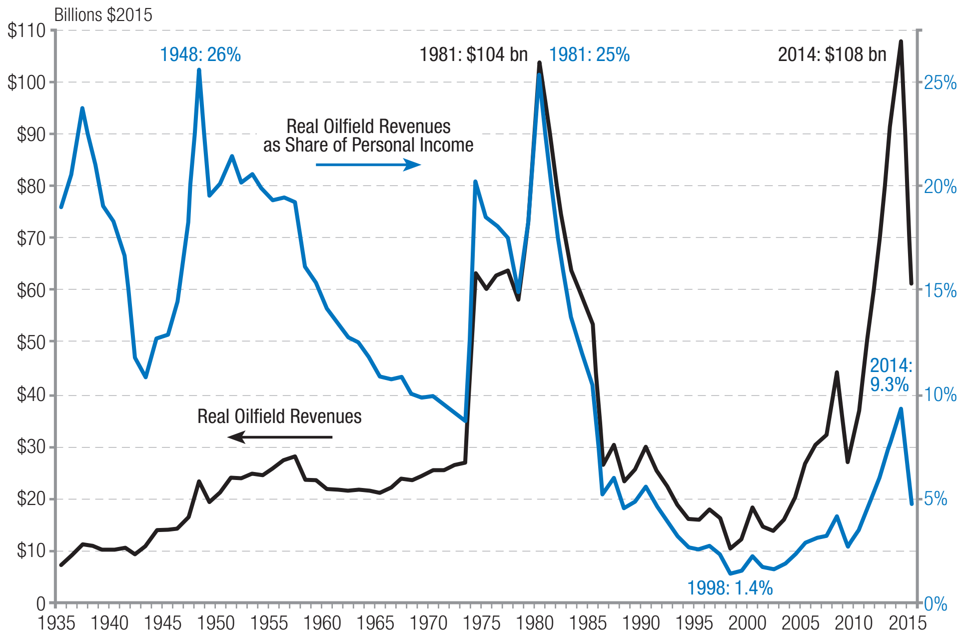
OIL PRICES FALL—BUT NO REPEAT OF TEXAS' 1980s SLUMP



BOOM OR BUST, OILFIELD REVENUES NOW FAR FROM PAST PEAKS



Back then, oilfield revenues' share of state personal income hit an all-time high of 26 percent (*see chart at right*). In 1981, oil's share of the economy once again spiked at 25 percent, largely because Texas benefited from OPEC's success in driving prices to unheard-of heights. With crude prices in a long-term lull, oil's share of state personal income hit its low point in 1998—just 1.4 percent.

Over the past six years, the development of hydraulic fracturing, or "fracking," technologies has helped restore Texas oil's mojo. Even with record production and prices above $100 a barrel, oil's share of state personal income rebounded to only 9 percent in 2014. A year of falling prices has sent oil back to less than 5 percent of personal income.

Even the state government now depends less on oil money. When crude prices and production were high from 1981 to 1983, the oil sector's contribution to state revenues averaged 12 percent. In recent years, real oil prices have been as high as they were in the early 1980s, but oil has provided less than 5 percent of state revenues since 2012.

Texas still faces vulnerability to low oil prices—but it shows up mostly in industry and regional data. By early 2016, just about all drilling activity had stopped. Midland, the hub of the oil-rich Permian Basin, has seen employment fall more than 5 percent since February 2015 (*see chart below*).

Like the state as a whole, Texas' big metropolitan areas have continued to add jobs in the past year. Employment rose 4.5 percent in Austin, 3.6 percent in Dallas-Fort Worth and 2.7 percent in San Antonio. Energy-dependent Houston managed to eke out a small gain in jobs, a testament to the metropolitan area's increasing diversification.

Oil and related industries remain an important part of the state economy. However, the business that had symbolized Texas for so long has become far less dominant as the state's entrepreneurs and businesses expanded other industries, giving the state economy a wider, sturdier foundation.

Let economic freedom ring

Commentators outside Texas like to portray the state as being just plain lucky, living off the bounty of the ancient seas that left behind the dead plants and animals to morph into oil and gas deposits that have enriched Texas for more than a century (*see The Texas Economy,* February 2016).

That oil-soaked view may have been true in the past, but not today. Texas' rapid diversification points us to the real reason for the state's success: a high level of economic freedom. The latest *Economic Freedom of North America* index finds Texas tied with Florida as this country's third most economically free state, just slightly behind New Hampshire and South Dakota.

Texas' high ranking in the latest economic freedom report isn't a fluke. Since the first index in 1980, the state has never been below seventh—and in many years, it has ranked No. 1.

Keeping taxes, regulation and public spending low, while allowing labor markets to function with few restraints,

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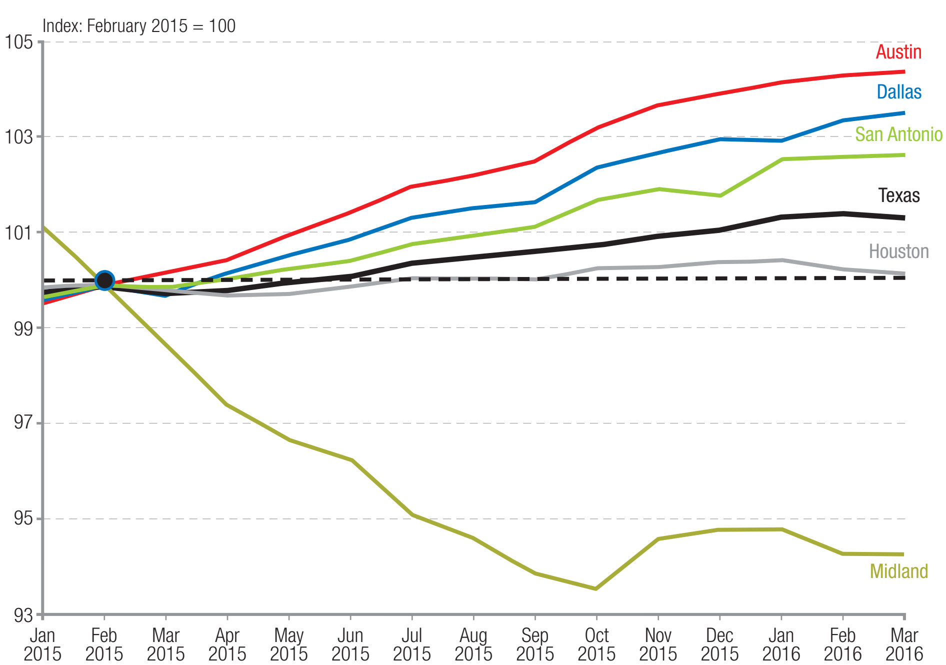
MOST TEXAS MSAs CONTINUE TO GROW WITH LOW OIL PRICES



has freed the Texas economy from the heavy hand of government, giving greater scope to markets to efficiently reallocate resources, create jobs and drive growth. Texas' business-friendly policies have attracted companies and migrants from other states and the rest of the world. From 2004 to 2014, net in-migration to Texas totaled 1.34 million, doubling the gains of second-place Florida.

States that rank low in economic freedom, like New York and California, saddle their companies and workers with high taxes and regulations, sapping incentives for business expansion and job creation. These heavy burdens slow economic growth and lead to out-migration. New York and California lost a combined 2 million from 2004 to 2014. More relocating Californians went to Texas than any other place. Most ex-New Yorkers headed to Florida.

People "voting with their feet" may signal a preference for greater economic freedom—but less-free states remain reluctant to emulate Texas. It's easier for them to attribute Texas' boom to oil rather than acknowledge the superiority of the state's model of greater economic freedom.

Even in the oil business, economic freedom makes a difference. In Texas, the government didn't stand in the way as entrepreneurs like George Mitchell developed the fracking technologies that reversed the long-term decline in U.S. energy production.

An arm of the gas-rich Marcellus Shale formation extends beneath New York, but that state has passed laws that effectively prohibit fracking. California imposes strict rules that put much of its offshore oil deposits off limits to development. Greater economic freedom would have allowed either state to benefit from economic activity that creates wealth and jobs.

When looking at countries blessed with natural resources, economists often talk about "the Dutch Disease"—a shorthand for the repercussions of the Netherland's discovery of oil in the North Sea. The term describes how outsized money inflows from oil, minerals or commodities disadvantages the economy's non-resource sectors by distorting prices and exchange rates. These sectors struggle to compete and eventually shrivel, leaving the economy even more dependent on its cash cow and vulnerable to wild swings in prices.

In an environment of economic freedom, two decades of low prices gave Texans and in-migrants incentives to develop the non-energy parts of the economy.

Texas might have been headed that way in the 1980s; continued high oil prices probably would have left the state more skewed toward energy production. The recent decline in oil prices would have had dire consequences for the overall Texas economy.

Fortunately, the oil bust shunted the state's economy onto a different track. In an environment of economic freedom, two decades of low prices gave Texans and in-migrants incentives to develop the non-energy parts of the economy. With the benefit of hindsight, the hard times Texas endured three decades ago come clearly into view as a blessing in disguise.

Now, Texas' economy stands out as one of the nation's most diverse—a topic we intend to explore in a future issue of *The Texas Economy*. Many parts of this highly diversified economy benefit from low oil prices—the airlines, the farm sector, and the petrochemical complexes along the Gulf Coast.

It would be too much to say that Texans should start cursing higher oil prices. In the past six years, as prices rose to more than $100 a barrel, Texas added a booming oil sector to a broadly diversified economic base and grew faster than any other state. Oil is now the icing on the cake, a boon when prices are high but no longer a bust when prices fall.

In the past two decades, oil and gas have become far less important; non-energy businesses carry greater weight, and Texas' economy doesn't need high oil prices to continue growing. As long as they last, low oil prices will take some of the sizzle out of Texas' economy, no doubt. But the oil industry will no longer determine the fate of the state.

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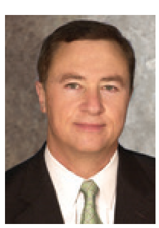
Next issue: *The Texas Economy*'s historical series resumes with the story of how the state took on the first big challenge in building an economy—attracting settlers to a remote and dangerous part of the world.

About the Authors



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CHARTING THE TEXAS ECONOMY

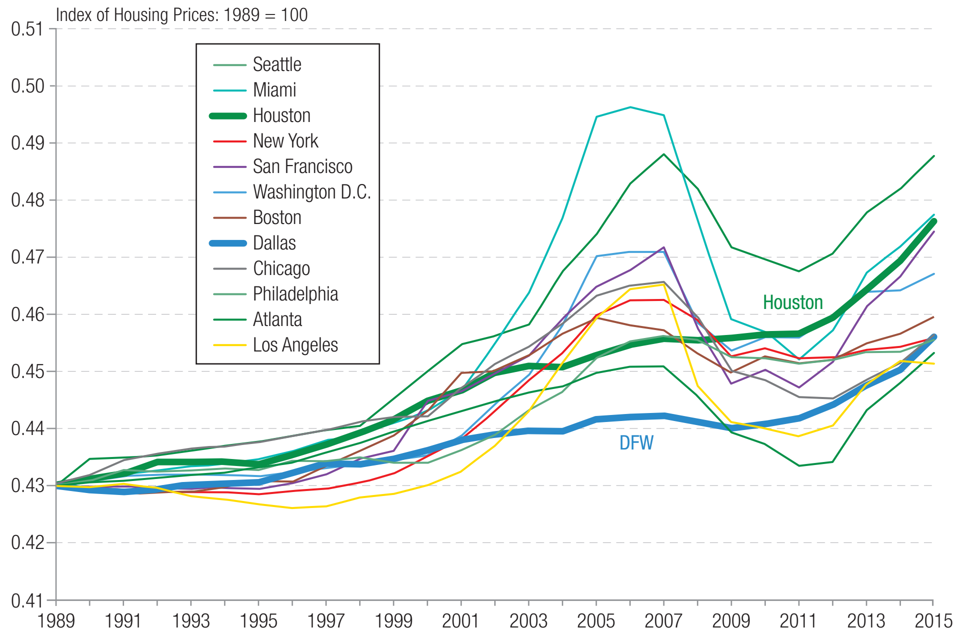
Housing Prices Lower, More Stable in Texas' Biggest Metropolitan Areas

Housing prices are a key component of differences in the cost of living in major metropolitan areas, including Dallas-Fort Worth (DFW) and Houston.

According to National Association of Realtors' data for the nation's 12 largest urban areas, the two Texas cities' housing markets have been relatively calm through the past quarter century's booms and busts.

The housing bubble of 2002 to 2007 more or less bypassed the DFW area (*thick blue line*). In those years, prices for existing single-family homes rose slightly faster in Houston (*thick green line*) than in DFW, but most other metros had much larger run-ups, which set them up for chilling plunges when the housing bubble burst.

Since 2011, housing prices have been rising in all 12 metropolitan areas—more in some, less in others. Atlanta has had the largest price increase—84 percent. DFW's gain of 45 percent ranks as the fifth largest; Houston is next at 42 percent.



In this housing cycle, DFW and Houston are looking more like other big cities, eroding the Texas cities' edge in affordability. Texas' bustling economy and growing population are fueling demand for housing, while new building hasn't been able to increase supply fast enough to keep pace.

ABOUT *THE TEXAS ECONOMY* AND THE O'NEIL CENTER

The Texas Economy is an electronic publication of the William J. O'Neil Center for Global Markets and Freedom, a research institute in the SMU Cox School of Business.

The center was founded in 2008 with an initial grant from William J. O'Neil, a 1955 SMU business school graduate, and his wife Fay C. O'Neil. Its broad mission is the study of why some economies prosper and others do poorly, focusing on two critical issues for the 21st Century economic environment—globalization and economic freedom.

The center's programs promote understanding of how capitalism works among the general public, policy makers, business managers and the next generation of business leaders. To these ends, the O'Neil Center teaches SMU Cox students, conducts economic research, publishes economic reports, sponsors conferences and educates the public through the media and speeches.

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