Recovery for Texas Economy Projected Below the U.S. Growth Rate

The Texas economy lost 1.7 percent of its nonfarm employment during the first three quarters of 1986 (see Chart 1), but the economy is likely to turn up modestly in 1987. Continued growth in the service-producing sector, some increase in manufacturing, and a slower decline in energy-related industries will contribute to the turnaround. The 1986 decline—linked to an energy industry slump, a drop in construction, and problems tied to foreign competition—was the first in more than two decades to occur in a period of national growth (see Chart 2). The slow growth likely for 1987 means only small declines are probable in the Texas unemployment rate.

Projections on Major Factors in State's Recession: Mixed

The outlook for 1987 crucially depends on the same three major factors that caused the state's 1986 slump. The energy-industry decline will slow in 1987. During 1986, the Texas drilling rig count fell to below half its depressed level of the end of 1985. Oil and gas extraction employment dropped 23 percent during the first nine months of 1986. Because 1987 oil prices are unlikely to fall below those for this year, the large 1986 layoffs will not recur, but energy-linked employment should still decline some.

The state's high vacancy rates and low absorption rates contributed to a downturn in construction values and—along with changes in U.S. tax laws—will lead to further declines in 1987. By third quarter 1986, contract construction values had fallen 28 percent below a year earlier. Because most of the decline in construction contract values occurred early in the year, much of the employment impact will have been felt by the end of 1986. Declines in 1987 contract values will reduce employment further.

The intense foreign competition linked to the high value of the dollar will abate in 1987. Foreign competition caused weakness in the semiconductor industry, textiles, garment manufacturing, primary metals, and oil field equipment. A number of Texas manufacturers report that past declines in the dollar have already led to an easing of foreign competition in their industries and to upturns in their orders.

Defense and Services Continue Growth

Defense-related and service-producing industries will continue their expansions. The value of Department of Defense prime contracts in Texas rose by more than 12 percent during fiscal 1986. The smaller rate of increase for defense contracting likely in 1987 will (Continued on back page)

Oil Price Decline Could Alter Tax Structures for District States

The drop in oil prices has dealt a severe blow to the economies of the Eleventh District states and has also reduced state revenues from severance taxes based on the value of natural resource production. Severance tax collections have provided a relatively large share of the tax revenues in Texas, Louisiana, and New Mexico, despite declining oil and gas production. Even though the OPEC-induced oil price hikes formerly offset the decline in production, it was inevitable that a shift in taxes would occur unless prices had continued to increase. Population and income growth have led to increased government expenditures and a greater need for tax revenues at the same time that the severance tax base has declined.

District State Tax Structures Energy-Dependent

Nationally, severance taxes account for only about 2 percent of revenues for state governments (see Chart 3). Texas, New Mexico, and Louisiana, however, can be distinguished from the remainder of the United States by their heavy reliance on severance taxes. For the District states, these taxes have provided about one-quarter of the state tax revenues, thus reducing the tax burden on the nonenergy sectors. Because of this reliance on severance taxes, the proportion of revenues provided to District states by broader based taxes, including the corporate and personal income tax and (Continued on back page)
The Eleventh District economy remains weak, although there is evidence that the decline has ended.

- After marked job losses during the first half of the year, nonagricultural employment has been steady in recent months. Although employment in construction, manufacturing, and oil and gas extraction has fallen, business and personal services employment has resumed growing at a fairly rapid pace. Job losses continue in Louisiana, which is the most energy-dependent state in the District. In New Mexico, total employment has been relatively steady.
- The relative stability of oil prices has induced some new drilling. Since September, the rig count in the District states has increased slowly but steadily. The number of drilling permits issued in the District states continues to increase, portending added gains in the rig count.
- Construction has been stable in recent months, but slackened demand and overbuilding have left activity far below year-earlier levels. The sharpest decline has been in nonresidential building as office construction has contracted dramatically. Residential building has also been weak, but the greatest declines have occurred in multifamily construction, where the number of permits issued is 70 percent below last year's level.
- Manufacturing has been hard hit by the decline in drilling, weakening construction, and import competition. In Texas, manufacturing employment has fallen steadily. Rising defense orders have partially offset some of the decline, with employment strong in aircraft and parts.
- The impact of the sluggish economy on District banks has continued. At the large banks, loan growth has slipped markedly, and total deposits at these banks have contracted sharply.

**UNEMPLOYMENT RATE**

- **12 PERCENT**
- **(QUARTERLY AVERAGES, SEASONALLY ADJUSTED)**

**HOUSING PERMITS IN TEXAS**

- **24 THOUSAND**
- **(QUARTERLY AVERAGES, SEASONALLY ADJUSTED)**

**CONSUMER PRICE INDEX**

- **8 PERCENT**
- **(SEASONALLY ADJUSTED)**

**TEXAS INDUSTRIAL PRODUCTION INDEX**

- **320 (1967 = 100)**
- **(QUARTERLY AVERAGES, SEASONALLY ADJUSTED)**
Texas Recovery (cont.)
still contribute to the state’s growth. Service-producing employment is above a year earlier and will rise in 1987, continuing a long-lived pattern in both the United States and Texas.

Favorable Projection for 1987 Could Depend on Construction Sector
U.S. growth, a rebound in manufacturing, continued expansion in service-producing industries, and further rises in defense contracting activity will lead to an upturn in the Texas economy in 1987. Nevertheless, weakness in energy and construction will keep the rate of increase below the nation’s. The risk in any economic forecast for Texas in 1987 involves how much construction values and employment could fall.

—William C. Gruben

Oil Price Decline (cont.)
the sales tax, currently is less than in the rest of the United States.

In the past, severance taxes have been important in the District states because of the significant production of oil and natural gas. Despite declining production (see Chart 4), OPEC-engineered oil price hikes have kept severance taxes a major source of revenue.

An example of the combined effect of declining production and falling prices can be seen in Texas. Per capita oil and gas severance tax revenues (adjusted for inflation using 1967 dollars) jumped from $21 in 1973 to $60 in 1981. At a time when population and income growth increased demands for government services, the gain in severance tax collections allowed these states to meet growing demands without raising other taxes. But when energy prices stopped increasing, state budgets became pressured. Since 1981, the combination of falling prices and declining production have pushed down real per capita tax revenues in Texas to $25, an amount just above their 1973 levels.

Tax Shift to Nonenergy Base Likely
Given current market conditions, it is unlikely that oil and natural gas prices could rebound enough to restore the former level of severance tax revenues. For Texas, oil prices would have to approach $40 per barrel to restore per capita tax revenues to their 1981 peak. Natural gas prices would have to increase by a similar magnitude. Thus, unless government expenditures are cut significantly, the taxes on the nonenergy sector will have to be increased to replace the revenues lost from the energy sector.

—Roger Dunstan

The views expressed are those of the authors and do not necessarily reflect the positions of the Federal Reserve Bank of Dallas or the Federal Reserve System.