

A Conversation with James Gaines

Texas Home Prices to Keep Rising Despite Energy Slowdown

James Gaines, chief economist of the Real Estate Center at Texas A&M University, is a leading authority on housing and development issues in Texas. He discusses the supply and demand conditions that have led to rapidly rising house prices, as well as the unique role municipal utility districts (MUDs) play in single-family housing construction in Texas.



Q. Texas never had much house price appreciation because there was so much building. What's happening now?

Texas has not had the extreme home price volatility that other areas of the country experienced mainly because homebuilders could produce a substantial number of homes at comparatively modest cost to keep the market well-supplied.

Even during past booms—such as the 1970s and early 1980s—Texas markets lacked substantial price increases. This was in marked contrast to other states, especially California and Florida. They and many of the other high-growth, high-population states had much more restrictive housing and land-use policies limiting new home production and leading to significantly higher home prices.

The difference today is that Texas homebuilders have been unable to recover from the financial crisis and Great Recession of 2008–09 to supply the state and our major metro areas with sufficient new housing. The phenomenal increase in jobs and population in the major metro areas during the past six years, coupled with historically low mortgage interest rates, created such housing demand that prices have risen at more than twice the long-term historical rate of around 4 percent per year.

Q. Is the price appreciation you speak of due to supply- or demand-side factors?

The answer is no doubt both. Between 2010 and 2015, Texas added more than 1.45 million jobs, about 290,000 per year on average. During the same period, the state gained nearly 2.55 million people, or an average of nearly 510,000 people per year.

On the supply side, the number of new homes built could not keep pace. Single-family permits in 2011 were the lowest since 1992 and only regained their long-term average level by 2014. Although new-home construction in 2014 and 2015 exceeded the long-term average, the amount was nearly 35 percent less than the peak years of 2005–06. The balance of the increased demand for housing was filled by the substantial addition of rental units. Construction permits for multifamily units spiked in 2012 and continued to increase through 2015.

Q. To better understand supply-side constraints, what's the process of developing a new community of single-family homes?

The business model for developing residential subdivisions in Texas typically involves a land developer who acquires a tract of raw land and transforms it into residential lots. The land development process involves acquiring land (some-

times assembling multiple parcels), platting and permitting a subdivision, engineering the land and building roads, utility lines and other necessary improvements before marketing the finished lots to homebuilders or owners. This basic process covers anything from a few dozen acres of land to master-planned communities comprising thousands of acres.

The next step is building and marketing individual housing units—the role of homebuilders. In some cases, the role of land developer and homebuilder might involve the same entity, but until recently, quite often it did not.

Regulators play an integral role—from the state to the county and municipal layers of government—applying standards for zoning, minimum lot size, roads and utilities, and building, fire, plumbing and electrical codes.

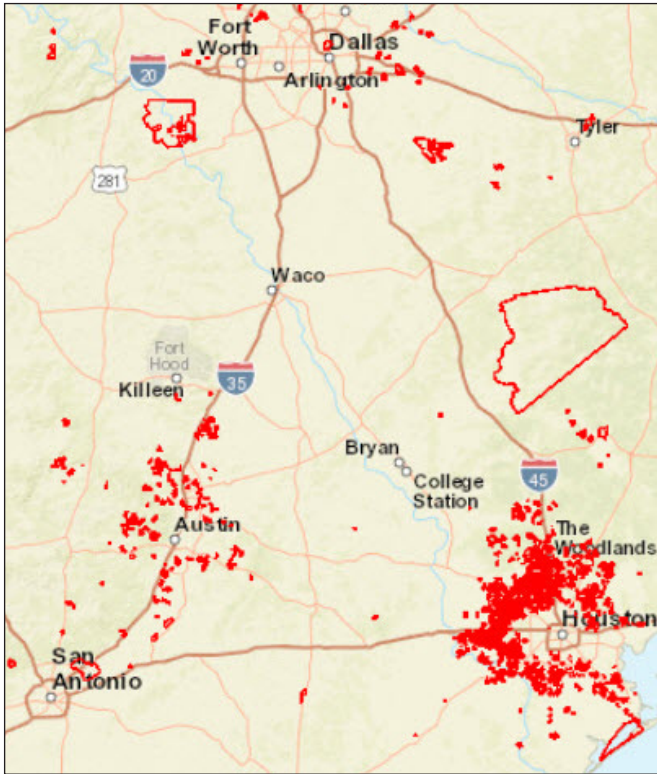
During periods of rapid population growth that fuel the need for fast development of housing, counties and cities are often unable to keep pace to provide such services as roads and water/sewer capacity for new subdivisions. Sometimes a local government may try to control growth by limiting new subdivision permits, charging local impact fees for road and water/sewer services or changing density and affordable-housing requirements or other aspects of the development process.

All of these activities limit supply by adding to the time and cost of development, thereby raising the price of new housing. Restricting supply, especially in the face of rising demand, causes all housing to be more expensive.

Q. Developers' ability to establish municipal utility districts (MUDs) was one reason Texas housing supply was so elastic for decades. What are MUDs, how are they created and how do they help expand the supply of new homes?

A key part of the subdivision development process is ensuring adequate water and sewer services for houses being built. If a local municipality is unable to provide utility services or, more often, if the development is located in an unincorporated area, a developer can create a MUD to undertake the task.

Municipal Utility Districts Concentrated in Metro Houston



SOURCE: Texas Commission on Environmental Quality, 2016.

MUDs have been crucial in allowing an adequate housing supply and keeping home prices lower than in other high-growth states. Without MUDs, or some other means of financing local infrastructure to accommodate a rapidly expanding population and escalating housing demand, new-home construction would be severely limited and much more expensive and overall housing costs would escalate. That's what happened in such high-growth areas as California and Florida, where supply was constrained by local infrastructure development and highly restrictive, costly land-use regulations.

In Texas, the Texas Commission on Environmental Quality (TCEQ) oversees the creation of MUDs, which provide water, sewage treatment, drainage, garbage, firefighting and other services to a defined area—all or part of a proposed subdivision or community development. A MUD may issue bonds, levy and collect property taxes, charge for services provided, condemn property, enforce restrictive covenants and make other necessary regulations to accomplish its purposes.

A developer may petition the TCEQ

to create a MUD by paying at least 30 percent of the cost of the subdivision utilities or providing a letter of credit. Typically, the developer funds the initial cost of building the water/sewer facilities and drainage improvements where necessary—and the MUD issues bonds. The developer is reimbursed from the proceeds. The level of MUD bond indebtedness assumes a projected property tax base as the subdivision is developed. The MUD becomes the

owner and operator of the utility and has an independent board of directors.

Q. Are MUDs still the best way to finance and maintain community infrastructure?

The debate on the best way to finance local, community infrastructure generally involves who pays for future growth—current residents or future residents. Most communities want and solicit growth through economic development efforts and other initiatives.

For existing residents, it may mean higher property tax rates or current user fees to pay infrastructure capital development costs to provide services to future residents. Current residents often want the future residents to pay for the facilities that newcomers will need and use. MUDs allow subdivision developers to front the initial utility capital costs and get reimbursed by taxing the future property owners.

Q. What is the current status of creating a MUD? What has changed from previous housing cycles?

Over the years, the specifics of creating a MUD have remained essentially

the same. TCEQ has established detailed requirements to create, fund and operate a MUD. Following some MUD bond defaults that occurred during the oil bust of the 1980s, probably the biggest change involves more rigorous evaluation and approval processes of the economic feasibility analyses that support the estimates of future property values and tax rates to back any bond issues.

Q. MUDs were particularly prevalent in Houston. Is that still true?

MUDs are located all over Texas but have been used extensively in the Houston metro area. Houston experienced unprecedented population growth in the 1970s through the first half of the 1980s, during the oil boom. None of the local communities had the financial capacity to deal with the pace of growth for housing. Without MUDs or something like them, Houston would probably be another very-high-cost housing market similar to the major markets in California. MUDs were not as plentiful in the Dallas-Fort Worth metroplex because much of the growth occurred in existing small towns and incorporated areas.

Q. Given the oil price decline, what's the outlook for housing construction in Texas?

The outlook for residential construction remains strong despite the effects of lower oil prices on the general economy. The demand momentum built up over the past five years from job creation and rapid population growth will push the housing market through at least the rest of this year. A greater number of young people are forming new households and looking to enter into homeownership as they marry, have children and wish to move beyond renting.

As demand has risen, affordability has become an ever-pressing issue for intraurban as well as suburban housing. Higher land and materials costs, coupled with relatively short labor supply, caused new-home prices to expand rapidly. In order to produce even moderately lower-priced housing, land developers and homebuilders have been forced to move further out into the suburbs and away from incorporated areas.