Will Office Real Estate in Texas Ever Recover?

Growing employment, tax breaks for real estate investors and abundant credit caused a flurry of investment in office development in Texas during the early 1980s. Skylines dotted with new office towers and busy construction projects symbolized a booming real estate market. Investors, encouraged by new tax laws that favored office development over housing, poured money into new buildings.

In 1986, however, the boom in building activity came to a grinding halt. Since 1986, real estate investors have endured falling rents and declining building values. Office demand, once projected to keep growing at the furious pace of the 1980s, instead has dissipated. Today, office vacancy rates in most major Texas cities exceed 20 percent, a level that is well above the national average. What happened to Texas' office real estate sector, and when, if ever, will it recover?

The Rise of the Texas Office Market

The Texas real estate boom came on the heels of the state's oil boom. The oil boom had accelerated the rate of Texas' economic growth and spurred creation of new jobs in most sectors of the Texas economy in the late 1970s and early 1980s. Despite a national downturn and a decline in oil prices in 1982, the Texas real estate sector continued to grow steadily, mainly because real estate tax incentives had increased and a vast supply of money was available for lending.[1]

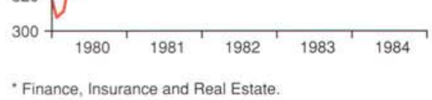
Interest in real estate development heightened after the passage of the Economic Recovery Tax Act of 1981, which gave significant tax advantages to commercial real estate investors, including investors in office space.[2] The most noteworthy element in the 1981 tax law was a major change in business depreciation allowances. The new law significantly reduced tax lifetimes of certain depreciable assets, such as industrial plant and equipment and real estate properties other than owner-occupied housing. The effects of shortening the period over which an asset can be depreciated are a reduction in the effective tax rate on the lifetime income generated by the asset and accelerated recovery of investments.[3]

The 1981 tax law was especially attractive to high-income investors, who could buy into real estate through limited partnerships and deduct depreciation costs from personal or other business income. The law resulted in a surge of investment in commercial real estate, including office buildings. At the same time, a sharp drop in interest rates motivated many investors to shift out of the bond market and into commercial real estate.

While more people were willing to put money into office real estate, financial institutions were acquiring a larger pool of available funds to lend to real estate investors. The Depository Institutions Deregulation and Monetary Control Act of 1980 accelerated the deregulation of deposit interest rates by providing an eventual phaseout of interest rate ceilings on time and savings deposits. In addition, the Garn–St Germain Depository Institution Act of 1982 created a new account, the money market deposit account, or MMDA, which was competitive with unregulated money market funds.[4] As these new accounts became available, a flood of money poured into banks and thrifts. Meanwhile, the same monetary easing that initiated a decline in interest rates in 1982 added to banks' liquidity. Together, these factors created a large source of funds from which banks and savings and loan associations could lend. Texas lending institutions, which had prospered greatly from energy loans in the late 1970s, were searching for new, profitable investments, and real estate lending was the outlet they chose.

At the same time that real estate became an attractive investment, many observers viewed Texas as having one of the strongest economies in the nation. The state gained more than half a million jobs from 1980 through 1981, and Texas was expected to be a growth leader throughout the decade. Meanwhile, the rest of the country was in the midst of an economic dowturn, which increased the large inflow of investment capital to finance

Chart 1
Texas Construction, FIRE and Energy Employment



* Finance, Insurance and Real Estate.
SOURCE: Federal Reserve Bank of Dallas.