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Is Texas' Real Estate Boom a House of Cards?

Ten years ago, the Texas real estate and construction industries were booming. But by 1986, a plunge in oil prices, a statewide recession and federal tax law revisions had sent the state's construction activity and real estate values into a free fall. What was once the land of oil derricks and construction cranes had become the land of see-through skyscrapers and vacant apartment buildings.

After the crash, construction and real estate activity grew little for the rest of the decade. Demand for real estate was stagnant, and construction was next to nil. In the 1990s, however, activity began to pick up. Since 1991, demand for almost all types of real estate has rebounded, resulting in rising occupancy and rents for apartments, office buildings and retail space. The higher demand for real estate has also boosted construction activity and employment. But is this growth solid, or is the Texas real estate rebound just another house of cards?

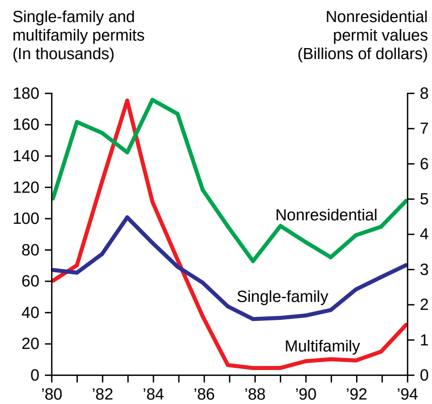
"If You Build It, They Will Come"

Texas' 1980s real estate boom followed the oil boom that started in the late 1970s. Oil prices spiraled upward between 1978 and 1981 and spurred job growth across the state. People and firms flocked to Texas, and construction activity soared. But much of the economic growth was based on speculative expectations. Oil was king, and "$85 by '85" became a rallying cry among investors.

Oil prices edged down in 1982, but even that, coupled with the spillover effects of a national recession, didn't quell construction growth in Texas. Home and apartment building surged, and construction of offices and other nonresidential structures remained at very high levels (*Chart 1*). The Economic Recovery Tax Act of 1981 was one likely reason construction continued to increase. The act created significant tax breaks for apartment and office building investors. Basically, the new law gave investors and builders incentives to build without much regard for demand.

Another culprit in the 1980s real estate buildup may have been a so-called lending frenzy. Two major banking laws were passed in the early 1980s giving financial institutions a larger pool of funds to lend to real estate investors.[1] These laws,

Chart 1
Texas Construction Activity

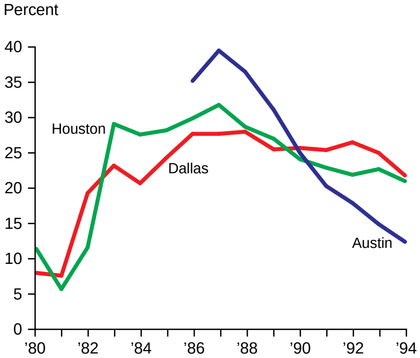


SOURCE: U.S. Department of Commerce, Bureau of the Census.

along with a monetary easing that initiated a decline in interest rates, added to banks' liquidity. Although these were national events, the lending frenzy was probably worse in Texas. Texas lending institutions that had been badly burned by energy loans in the 1970s were searching for new investments, and they chose real estate.

Unrealistic expectations of oil prices and economic growth, tax laws that favored investment in real estate and a lending frenzy combined to push financing and construction of real estate to a point

Chart 2
Office Vacancy Rates



NOTE: Austin data unavailable prior to 1986.
SOURCE: CB Commercial; 1980–82 values provided by Torto Wheaton Research.

of extreme oversupply. As Chart 2 shows, office vacancy rates rose rapidly during the early 1980s, even as construction continued. Excessive building during the boom made the bust especially painful. In 1986, oil prices tumbled, the state entered a recession and a new tax law eliminated certain real estate tax shelters. Construction activity plummeted to pre-1980 levels.

Where Are We Now?

In the 1990s, signs of life have returned to the Texas real estate and construction sectors. In fact, 1994 was the best year for these Texas industries since the boom days of the early 1980s. Last year, employment in the real estate-related sectors of the economy rose by 42,300 jobs, almost 17 percent of total Texas employment growth.[2] In addition, contracts for new residential and nonresidential construction rose 15 percent in 1994, and real estate values and rents began to pick up.

A rebound in the residential market led the real estate industry's recovery. Growing demand for housing and diminishing inventories led to an 84-percent increase in single-family home construction from 1990 through 1994. Also in the 1990s, many who bought homes at the 1980s peak could finally breathe a sigh of relief as home prices began to rise. As Chart 3 indicates, average home prices have surpassed their 1980s peak in most major Texas cities. The most dramatic increase has been in Austin, where 1994 prices reached $120,800, 9.6 percent above their 1986 peak. Apartment demand also surged. Texas apartment permits rose more than 100 percent in 1993 and 60 percent in 1994, and rents for new apartments have reached historical highs.

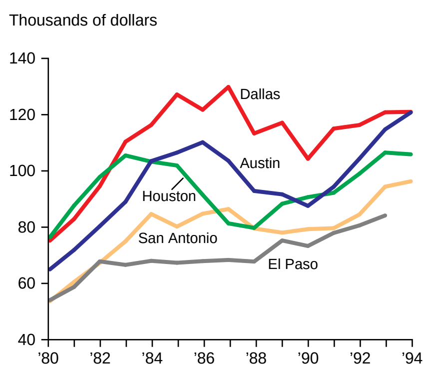
The real estate recovery is not limited to the housing sector. The market for nonresidential real estate, including retail, industrial and office space, also has improved. As demand increased and vacancy rates began to fall, nonresidential construction began to pick up in 1992 and took off in 1993 and 1994. Much of the growth is a result of retail and industrial construction.

Even the office market has made a comeback. Although construction levels remain low, rising demand for office space has caused vacancy rates to fall. In 1987, Austin had the highest office vacancy rate ever recorded in the state of Texas—39.5 percent. By December 1994, Austin had the lowest office vacancy rate of any major Texas city—12.4 percent. Dallas' and Houston's vacancy rates remain higher than the national average but have edged down in the 1990s.

On Solid Ground

Texas' construction and real estate sectors have come a long way since the bust, and the outlook is positive. The factors driving growth in the 1990s are based on the fundamental strengths of the Texas economy, unlike the more speculative factors that drove the 1980s boom.

Chart 3
Average Home Prices



SOURCE: The Real Estate Center at Texas A&M University.

One of the most important influences behind the construction and real estate recovery is Texas' strong rate of economic growth. In 1994, the Texas economy expanded at a faster pace than the nation for the sixth straight year. Unlike the expansion of the late 1970s and early 1980s, Texas' economic growth today is broad-based and not overly dependent on a single industry.

Rising job opportunities and numerous business relocations have drawn workers to Texas, boosting the demand for housing. In addition, the state's lower costs of living have enabled many newcomers to purchase homes or live in luxury apartments. Despite rising prices in recent years, home prices and apartment rents are below the national average in most Texas cities. The average price of a Dallas home, for example, remains about 10 percent below the national average.[3]

Texas' central location and proximity to Mexico are also contributing to the real estate sector's strength. Numerous companies have moved manufacturing facilities and distribution hubs to Texas. For example, Nokia Mobile Phones, Riddell Athletic Footwear, Nestle and Zenith have all chosen Alliance Airport in Fort Worth for national or regional distribution centers. Similarly, El Paso's industrial warehouse space is 97.5-percent full, a result of increased demand from manufacturers choosing to locate near Mexico.

In the 1990s, builders, investors and bankers appear to be taking care not to repeat the mistakes of the 1980s. Homebuilders are watching buyer demand, and when home sales slowed last fall, builders cut back on starts, keeping inventories manageable. Also, despite much new apartment construction, vacancy rates remain relatively tight, sug-

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ceived as signifying a more liberal attitude toward inflation.

Does this mean we should not worry about the government budget? Absolutely not. The empirical work has focused on periods when the deficit has been under 5 percent of GDP. Deficits larger than this could have more painful and more obvious economic effects. Furthermore, although the deficit per se may have no perverse economic effects, there is considerable evidence that the level and composition of government spending and taxation do. For example, the share of the economy's resources commanded by the public sector has risen by about one-third since 1945. Government spending now makes up more than one-third of total GDP. To the extent that this increased government spending has crowded out private expenditures, there is a real danger that resources have become increasingly misallocated, thereby lowering long-term growth.

Is the marginal value of a dollar transferred to government and spent by the public sector as great as it would be if left in the hands of private citizens? If not, then government has grown too large. Empirical work suggests that the private sector values the marginal dollar spent by the government only about one-fourth as much as a dollar left in the hands of the private sector. To the extent that growth in the public sector is a function of a budget process that allows the government to practice deficit spending, the budget process may be in need of change.

In addition, the structure of taxation and the composition of government spending may have important effects on growth. High marginal tax rates lower long-term economic growth by blunting incentives to work and save. Low levels of public investment in physical and human capital may mean insufficient spending on the physical infrastructure, education and training that are essential to a healthy economy.

Overall, the weight of evidence from economic research suggests that the ongoing debate over balancing the budget would be better focused, instead, on the larger issue of the proper role and size of government in the economy.

—Stephen Prowse

Notes

[1] This potential liability dwarfs the cost to the government of the savings and loan crisis, which totaled roughly $155 billion over four years.

[2] Proponents of the "deficits matter because bond markets believe they matter" school argue that such evidence does not conflict with their hypothesis because bond markets may believe deficits matter only at certain times; for example when the budget deficit is large relative to GDP by historical standards. Thus, the bond market may have become focused on the deficit in the mid-1980s and early 1990s when the deficit increased. Empirical studies over a long time period would not pick up this phenomenon.

Texas' Real Estate Boom

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gesting that construction is in line with demand. While vacancy rates have come down in the nonresidential sector, increases in speculative building are not evident.

Bankers' standards for real estate loans in the 1990s are much tougher than those of the early 1980s. Texas' wave of bank failures in the late 1980s forced the industry to impose strict underwriting standards and to scrutinize loans more closely. Despite a recent lending recovery in Texas and some easing of credit standards, banks rarely make real estate loans to developers without several committed tenants. Similarly, investors are more careful now. The Tax Reform Act of 1986 removed the tax incentive to invest in income-losing properties and reduced the attractiveness of real estate investments relative to other types of investments.

Real estate and construction are cyclical industries and will rise and fall along with fluctuations in the national and regional economies. But because the growth of these industries in the 1990s seems based on the fundamental strengths of the Texas economy, the next downturn should not trigger another 1980s-style bust. Today, the real estate sector's strength is grounded in economic reality. As long as developers, bankers and investors keep demand and supply in balance, the real estate and construction industries should prosper throughout the 1990s.

—D'Ann M. Petersen

Notes

[1] These laws were the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St Germain Depository Institution Act of 1982.

[2] In this article, real estate-related employment includes construction, lumber and wood products; stone, clay and glass products; furniture and fixtures, fabricated structural metal products; real estate; retail sales of construction materials and home furnishings.

[3] Likewise, commercial rents are low in Texas. The average cost for first-class Dallas office space at the end of 1994 was $17 per square foot, compared with $40 per square foot nationally.

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