REAL ESTATE REVIEW AND OUTLOOK 1987

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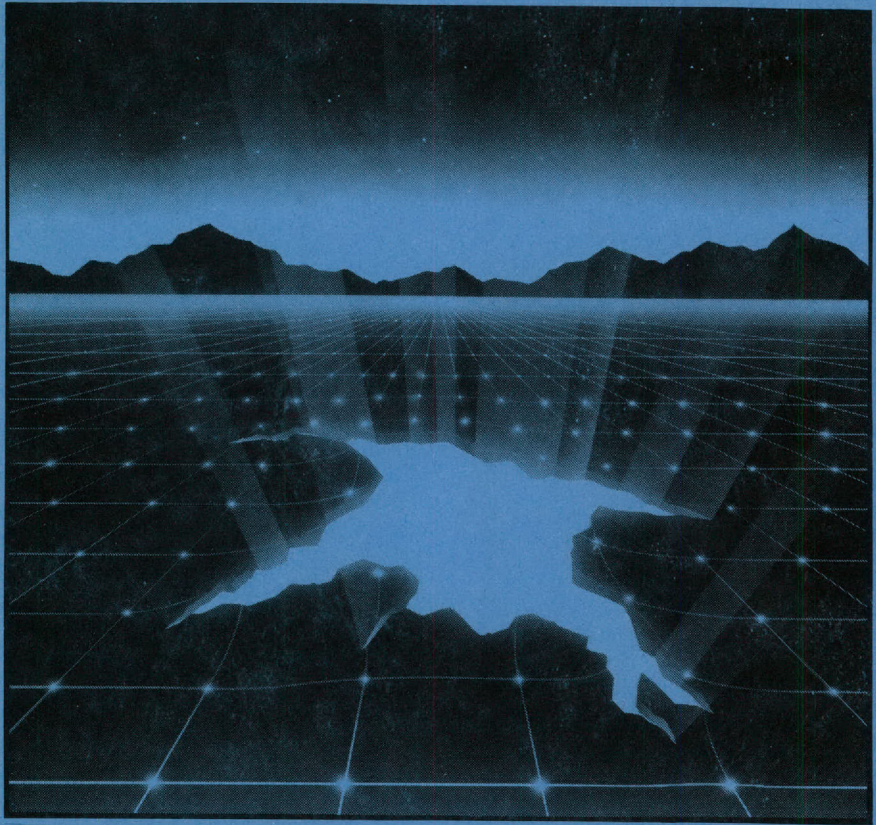

TEXAS REAL ESTATE RESEARCH CENTER · TEXAS A&M UNIVERSITY

REAL ESTATE REVIEW AND OUTLOOK 1987

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February 1987

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SUMMARY

In contrast to much of the country, Texas did not do well in 1986. The resounding fall in crude oil prices sent the state into an economic tail-spin. The new year promises to be a time of consolidating losses and preparing for impending recovery. It will not be an easy period for real estate, yet, for those committed to the long-term future, opportunities will exist.

- The state economy is bogged down primarily because of its dependence on natural resources. Building for future growth will require nurturing entrepreneurial skills. An encouraging note is the creation of many small businesses in Houston by former employees of oil related firms.

- Non-residential construction finally lost its impetus in 1986 as fewer new projects were generated. Excess inventories and investment penalties in the new federal tax law will depress activity for several years.

- Multifamily housing construction has fallen rapidly since 1984. Demographic trends, tax changes and increasingly affordable single-family homes will continue to keep production low. Single-family housing growth should be relatively stable, particularly in the less expensive market segments.

- Lower interest rates have made mortgage loans more accessible. However, this improvement is offset somewhat by tighter underwriting criteria and a lack of loans for certain types of homes. Foreclosure sales could be a good opportunity for many to purchase a home.

- Adjustable Rate Mortgages declined in popularity as interest rates fell. When they can afford it, borrowers appear willing to pay higher initial interest rates for fixed rate loans.

- The problem of foreclosures will continue into 1987, primarily as a result of falling property values in previous years. After a peak in activity, foreclosures should begin to decline later in the year.

- The outlook for interest rates is cloudy as usual. While high relative to inflation rates, mortgage rates are not out of line with other interest rates. A growing national economy and larger federal budget deficit could cause upward pressure on interest rates.

- The recession in Texas dampened the expected stimulus of lower interest rates on housing activity. Sales declined in 1986. These figures, however, may not include all foreclosure sales. Sales in 1987 could improve as buyers perceive that interest rates and prices may have bottomed out.

- For the first time since 1980, the average income household in Texas could afford the average-priced home. However, this situation could be temporary as interest rates and prices rise in future years.

• Activity in land markets continues to be slow as demand from investors and developers has declined sharply. Expectations are for significant price declines in 1987.

• The new federal tax law will have a chilling effect on the production and sales of income property. However, this may help prevent further increases in the stock of vacant buildings and may improve the appeal of projects with a good performance record.

• State taxes may increase in 1987 as the legislature begins to shift the tax burden from the depressed oil sector. The result will be higher costs for goods and services, including housing, to Texas consumers.

For the second year, the research staff at the Real Estate Center has reviewed the major issues facing the real estate industry in Texas and has subjectively forecast the implications for the coming year. Staff members, representing diverse research interests, combine their expertise to focus on the general review and outlook for 1987. Last year the staff correctly predicted the significant decline in non-residential construction, the continuing problems caused by mortgage foreclosures and the passage of federal tax reform that treats real estate investment harshly. However, the decrease in interest rates leading to improved housing affordability was a major surprise.

Undoubtedly, some of the expectations for 1987 will be incorrect as the economy persistently takes unanticipated twists and turns, making forecasts difficult. The object of this report, then, is not to foretell the future but to examine those factors that contribute to today's situation and to stress those developments that are likely to shape tomorrow's events.

Because the general economy is crucial to the real estate sector, the first section is an overview of the state economy. Construction, finance, housing markets, rural land and government policy are discussed in separate sections.

Like last year's report, this review paints a picture of an industry in recession and indicates that new challenges lie ahead. Rather than a temporary setback in an era of growth, the current period appears to be a major transition for the Texas economy, if not for the nation. There is much to do to restructure that economy for the future, a future that may look significantly different than the recent past.

THE STATE ECONOMY

The economic report card shown in Table 1 contains figures Texans are unaccustomed to seeing. Once a magnet for refugees from northern industrial decline, Texas now has increasing unemployment, and population growth is low for the heart of the sunbelt. Because income is rising at a rate below inflation, the average Texan has suffered a decrease in real income.

Undoubtedly, the primary source of this sad performance is the shakeout in the petroleum industry. The world-wide oil glut with its attendant free-fall in oil prices has taught the state a lesson in the consequences of overreliance on one industry. The slight discomfort caused by prices sliding moderately from earlier peak levels escalated to crisis proportions as prices tumbled with surprising speed. Virtually every segment of the Texas economy, including real estate, felt the repercussions.

The problems in the oil field were compounded by difficulties in other important sectors that fuel the Texas economy. Agriculture suffered from a glut of its own, threatening the viability of many farming enterprises. The burgeoning computer electronics field retrenched under competition from domestic and foreign rivals. There were few bright spots even in those parts of the state with relatively diversified economies.

Table 1. Recent Performance by the Texas Economy

Indicator	1985	1986*	% Change
Employment (millions)	6.682	6.678	-0.1
Personal Income ($ billions)	213.7	216.0	1.1
Inflation (%)	3.5	3.1	
Unemployment (%)	7.0	8.8	
Population (millions)	16.37	16.62	1.5
Oil Price ($/barrel)	26.77	16.87	-37.0

*Estimated
Source: Bob Bullock, Texas Comptroller of Public Accounts, February 1987.

Prosperity will come again but not quickly and not without further pain. A rise in oil prices might increase prosperity temporarily but is not the solution for a sound future.

The nation is maturing economically from an industrial power to a developer of innovative services. The future is seemingly in the hands of the entrepreneur who can provide new ideas. Other nations have shown they can produce goods more cheaply than the United States. Technical expertise and innovation are the keys to American competitive advantage. Those areas of the country which can nurture and sustain entrepreneurial activity will be the focal points of the new economy.

Despite the modern cities and high tech manufacturing plants, Texas still relies for its economic success on the land and the riches it can provide. Valuable minerals and fertile cropland have allowed the state to prosper in an industrial age. However, that prosperity was contingent on developing land-based resources rather than the intellectual resources of the population. Like many other mining and agricultural areas of the world, the state has yet to develop a clear vision and a sound foundation for long-term growth.

The entrepreneur to whom the future belongs will need few natural resources or little financial capital. Recruiting new industry will be distinctly different and more complex than in the past. The reservoir of technical expertise at the universities and the relative freedom from government interference in Texas will help attract brainpower. (Ironically, even economic disruption has stimulated entrepreneurial activity in Texas cities. A recent study showed Houston to be a national leader in new business starts, primarily by displaced corporate employees.) Sustaining such enterprise, however, will depend on producing a quality of life that makes the state a desirable place to live. Texas will need more than a mild climate to create this atmosphere. Growth will be enhanced by the existence of quality services, educational opportunities and an environment conducive to risk-taking and discovery.

The immediate outlook is for continued recession. Possibly, 1987 could be the worst year in the current downturn in many ways. The few signs of relief on the horizon are dwarfed when viewed from the perspective of the depths to which the economy has fallen. Somewhat higher oil prices in 1987 should help production in the private sector and state revenue in the public sector. Some short-term activity may spring from the interest shown by speculators attracted to apparent bargains in property and companies. However, the outlook for recovery is complicated by the possibility of a national recession brought on by the new federal tax bill and Congress' efforts to balance the budget. A national slowdown would weaken the markets for Texas' principal products at a time when growth is vitally needed.

CONSTRUCTION AND DEVELOPMENT

Large surpluses of buildings in almost every sector continued to discourage construction in 1986. The year marked the first major decline in non-residential construction in this building cycle. Especially hard hit were the lodging and office building industries, each of which had done relatively well in 1985. Apparently, projects committed or begun during better economic times accounted for the stability in 1985. Now that those projects are completed, permit activity has attenuated sharply.

Table 2. Texas Construction Permits, 1984-86

	Dollar Volume ($ million)			Percent Change	
Sector	1984	1985	1986*	1984-85	1985-86
Total	$16,288	$14,382	$11,300	-11.7	-21.5
Residential	8,232	6,402	4,900	-22.2	-23.4
Non-residential	5,896	5,788	4,200	-1.8	-27.2
Hotel, Lodging	349	385	175	10.2	-54.4
Industrial	404	353	280	-12.6	-21.2
Retail	1,849	1,779	1,600	-3.8	-9.8
Offices	2,180	2,169	1,200	-0.5	-44.6
Public	390	458	400	17.4	-11.6

*Projected from first nine months data.
Source: Real Estate Center, Texas A&M University

The construction slowdown will continue for some time. Low rental rates coupled with high vacancy rates and foreclosed projects have dried up construction financing. The market needs time to absorb the excess stock. In addition, the new tax law seriously discourages the production of "see through" buildings, projects that attract funds because of the tax benefits they provide to investors rather than their economic feasibility.

Overbuilding also has contributed to stagnation in residential construction. For years, Texas has produced more multifamily housing units than single-family units, in contrast to the national average of approximately two single-family units for each multifamily unit. Much of the state's multifamily housing stock is relatively new, but demand for this stock has fallen severely. Newcomers to the state, who tend to be more mobile and thus consumers of rental housing, have stopped arriving because of the economic recession. In addition, moderate income families who once rented can afford to buy a home more readily because prices and interest rates have declined. Also, demographic trends indicate a preference for homeowning over renting. Lower demand for multifamily units has created higher vacancy rates and therefore less new construction.

Table 3. Texas Authorized Dwelling Units, 1984-86

Sector	Dwelling Units (thousands) 1984	1985	1986*	Percent Change 1984-85	1985-86
Total	192	136	92	-30.2	-32.4
Single-family	82	64	56	-25.8	-13.1
Two-to-four unit	15	9	4	-44.1	-58.1
Five plus unit	96	58	3	-39.0	-43.3

*Projected from first nine months data.
Source: Real Estate Center, Texas A&M University

Another factor that may be reducing demand for multifamily housing is the declining interest in condominiums, townhouses and manufactured housing. When housing demand was growing and supplies were limited, many families opted for these alternative types of homes, and their popularity surged. With housing now relatively inexpensive, consumers are more free to obtain their preferred housing, the detached single-family home.

Unlike the non-residential sector, housing was affected by the recession years ago. Production figures for 1986 may represent the minimum levels that can be sustained in coming years. Indeed, multifamily production appears to be near minimum levels. Even with little growth in overall demand, some construction will be generated to satisfy specific demand for a particular type of housing and for certain locations. In other words, some new, well-located subdivisions may do well, while older developments fail.

Table 4. Top Ten Areas, 1986 Total Authorized Construction

Rank	MSA	Volume* ($ millions)	Rank in 1985	Percent Change 85-86
1	Dallas	4,321	1	-16
2	Fort Worth-Arlington	1,401	3	-27
3	Houston	1,389	2	-29
4	Austin	1,318	4	-27
5	San Antonio	823	5	-19
6	El Paso	349	7	44
7	Corpus Christi	144	6	-48
8	Killeen-Temple	140	-	4
9	Lubbock	137	9	-9
10	Galveston-Texas City	121	8	-25

*Projected from first nine months data.
Source: Real Estate Center, Texas A&M University

Table 5. Top Ten Areas, 1986 Non-Residential Construction Permits

Rank	MSA	Volume* ($ millions)	Rank in 1985	Percent Change 85-86
1	Dallas	1,780	1	-19
2	Austin	605	2	-32
3	San Antonio	469	5	25
4	Houston	410	3	-53
5	Fort Worth-Arlington	397	4	-22
6	El Paso	88	7	21
7	Lubbock	59	8	-9
8	Corpus Christi	58	6	-48
9	Killeen-Temple	50	-	115
10	Waco	42	-	35

*Projected from first nine months data.
Source: Real Estate Center, Texas A&M University

Table 6. Top Ten Areas, 1986 Residential Construction Permits

Rank	MSA	Volume* ($ millions)	Rank in 1985	Percent Change 85-86
1	Dallas	1,837	1	-20
2	Fort Worth-Arlington	759	2	-38
3	Houston	588	4	-1
4	Austin	527	3	-25
5	San Antonio	435	5	-7
6	El Paso	199	6	54
7	Killeen-Temple	90	8	-15
8	Galveston-Texas City	74	9	-25
9	Brazoria	59	10	-17
10	Lubbock	56	-	-14

*Projected from first nine months data.
Source: Real Estate Center, Texas A&M University

Dallas continued to lead in production by a wide margin. Most of the production leaders suffered large setbacks, however. Houston dropped from second to third because non-residential activity decreased by almost half. In contrast, Killeen-Temple entered the top ten list on the strength of a surge of non-residential permit activity.

Houston was once the production leader of the state (indeed, the nation) until problems in the petroleum industry reduced projects. The current leader, Dallas, has suffered some slowdown, but its economy is not as dependent on the oil industry as is Houston's. Therefore, it is unlikely that Dallas will experience the same type of prolonged decline. Austin, which has done well in recent years, is also more diversified, but any sharp cutback in state government activity could adversely affect construction in that city. The western border towns of Laredo and El Paso enjoyed increased construction during 1986 after years of stagnation caused by problems in the Mexican economy. While it is unlikely that any area will flourish in 1987, these border areas may be relatively stable because Mexican immigrants are attracted to these communities.

FINANCE

A large decline in interest rates at the beginning of the year made mortgages considerably less expensive. In many parts of the country, this development touched off a boom in housing construction and buying. In Texas, however, the overshadowing effect of the slow economy dampened the stimulus of lower interest rates. Moreover, most of the problems that characterized 1985 continued to plague Texas lenders.

Texas savings and loan associations continued to reduce their concentration in mortgage loans, although the dollar volume increased (Table 7). The growth of foreclosures and workouts of problem loans are shown by the increases in real estate repossessed or held for development by the associations. The volume of new mortgages closed was down in absolute terms for the first half of 1986, while foreclosures were much higher (Table 8). Texas associations continued to be active participants in the secondary market, selling about one dollar of mortgages for every two dollars originated.

These aggregate figures mask some of the more important changes in the Texas mortgage market. Because of high foreclosure and delinquency rates, lenders appear to be seeking higher quality loans: those with lower loan-to-value ratios and secured by owner-occupied, single-family homes. Financing for small income properties and condominiums, even when owner-occupied, is difficult to find in many areas. Therefore, although the terms of new loans are much more favorable than in the last several years, many borrowers may have difficulty obtaining a loan because of tighter underwriting procedures. The exception is financing for homes that have been foreclosed. These homes may prove to be bargains for those who purchase them.

Table 7. Assets Held by Texas Savings and Loan Associations, 1984-86

	Position as of End of June					
	Balances ($ billion)			Percent of Total		
Type	1984	1985	1986	1984	1985	1986
Mortgages and Securities	53.84	65.83	72.81	74.1	70.1	68.5
Non-mortgage Loans	4.36	5.82	6.83	6.0	6.2	6.4
Repossessed Property	.48	1.32	3.23	0.7	1.4	3.0
Real Estate Investments	1.02	1.46	2.45	1.4	1.6	2.3
Cash and Liquid Assets	7.13	9.91	9.31	9.8	10.6	8.7
Fixed Assets	.78	1.00	1.21	1.1	1.1	1.1
Other	5.03	8.52	10.53	6.9	9.1	9.9
Total Assets	72.64	93.85	106.36	100.0	100.0	100.0

Source: Federal Home Loan Bank Board

Table 8. Activity by Texas Savings and Loan Associations, 1984-86

Type	Semi-Annual Flow ($ billions) 1984 1st Half	1984 2nd Half	1985 1st Half	1985 2nd Half	1986 1st Half
Mortgage Loans Closed	11.84	11.47	12.37	12.90	10.95
Loans Purchased	3.15	4.59	3.66	4.41	4.02
Loans Sold	4.08	4.95	4.99	6.44	5.21
Net Deposit Gain	7.08	10.28	6.23	4.69	5.32
Mortgages Foreclosed	.35	1.05	.78	1.27	1.82

Source: Federal Home Loan Bank Board

Table 9. Adjustable Rate Mortgages as Percent of All Mortgages Closed by All Major U.S. Lenders, 1985-86

Year and Quarter	S&Ls ARM Share (%)	S&Ls Effective Int. Rate Fixed	S&Ls Effective Int. Rate ARM	Mortgage Banks ARM Share (%)	Mortgage Banks Effective Int. Rate Fixed	Mortgage Banks Effective Int. Rate ARM	Commercial Banks ARM Share (%)	Commercial Banks Effective Int. Rate Fixed	Commercial Banks Effective Int. Rate ARM
1985:1	56	13.65	11.76	36	13.53	11.46	29	13.60	11.71
1985:2	55	13.40	11.41	51	13.30	11.21	39	13.35	11.99
1985:3	53	12.63	10.55	50	12.42	10.07	43	12.54	10.57
1985:4	53	12.36	10.20	39	12.15	9.62	37	12.33	11.10
1986:1	46	11.27	9.73	18	10.81	9.36	24	11.26	10.47
1986:2	30	10.73	9.19	7	10.54	9.08	20	10.65	9.64
1986:3	34	10.81	9.00	8	10.57	8.79	25	10.72	9.46

Source: Federal Home Loan Bank Board

Because of lower interest rates, the demand for adjustable rate mortgages (ARMs) has declined. Fixed rate mortgages are the first choice of most borrowers and, when affordable, they dominate the market. With fixed rate loan contract rates at around 10 percent, ARMs have been relegated to a small share of the market. In late 1986, the spread between effective interest rates on fixed rate loans and ARMs was 130 to 180 basis points (national average) and this differential allowed ARMs to continue attracting some borrowers. Apparently gone are the deep discount "teaser rates" used to entice borrowers into ARMs a few year ago. (Teaser rates are low first-year interest rates applied to ARMs. When the rate is adjusted, it reverts back to the interest rate justified by the ARM index). Nevertheless, ARMs, even without the special rates, are still significantly cheaper in the first year than fixed rate loans. Borrowers who have trouble qualifying under fixed rates may accept an ARM to buy the home they want. In addition, many lenders in smaller markets offer ARMs exclusively. This is indicated by the extremely low share of ARMs originated by mortgage bankers, who usually operate only in the larger markets.

Although ARMs were instituted to help mortgage lenders solve the problem of matching long-term assets to short-term liabilities, they have not proved a boon to lenders in recent years. Many were originated at artificially low interest rates and some lenders probably assumed ARM rates would increase when they set the terms on the loans. Interest rates have been falling since their peak in the early 1980s, thus many ARMs have been adjusted downward. But, when ARM rates were advancing, delinquencies were a problem. Therefore, lenders have found the uncertainty of ARMs as much a problem as have borrowers. The outlook is for ARMs to remain an important, but minor, part of the market.

The reduction in interest rates in early 1986 surprised most observers. Single digit mortgage rates, once a wild dream, are now a reality. Rates however, are still higher than they were during much of the last decade. The question is, will rates continue to decline?

There are some reasons to expect further reductions. Based on recently low inflation rates, "real" interest rates are historically high, about 6 to 7 percentage points higher than current inflation. The new tax law might depress interest rates because of the reduced taxation of interest income. In addition, if a recession hits the nation in 1987, demand for borrowed money will decline, adding downward pressure on interest rates.

There are even more reasons why rates could rise. Federal debt financing still hangs over the capital markets, despite the efforts of the Gramm-Rudman law to reduce the federal deficit. If foreign investors reduce their presence in helping to finance the national debt, the treasury will be forced to enter the domestic markets with new issues, thereby crowding out other credit needs and pushing up interest rates. Any rekindling of inflation might raise inflation premiums with particularly adverse consequences for long-term interest rates. Mortgage rates before 1980 were based on the availability of low interest bearing deposit accounts. Since that time, regulations on ceiling yields on these accounts have been phased out. Therefore, mortgage interest rates should be more in line with other interest rates in the economy. Finally, foreclosures and lender losses could raise risk premiums on loans, leading to higher interest rates (although these premiums probably would come in the form of higher origination fees and discount points on mortgage loans). In short, rates could go either way, but toward year's end they are more likely to rise slightly above those prevailing in late 1986.

Table 10. Foreclosure Rates*, Savings and Loan Associations, First Half 1986

Area	Mortgages Foreclosed	Conventional & FHA/VA Mortgages Held	Rate (%)
	($ billions)		
Austin	120.0	3,771.3	3.2
Dallas	447.0	15,253.0	2.9
El Paso	8.4	547.9	1.5
Fort Worth	43.9	625.9	0.7
Houston	477.4	15,821.0	3.0
San Antonio	54.9	3,836.0	1.4
Texas	1,815.2	62,057.9	2.9
United States	6,126.9	689,078.2	0.9

*Dollar volume of loans foreclosed during period as percentage of conventional and FHA/VA mortgages held.
Source: Federal Home Loan Bank Board

Foreclosures continued to be a major problem in 1986. During the last several years, the foreclosure rate in Texas has gone from one of the lowest in the nation to one of the highest. There are some signs that foreclosures may decline in the future. Many homeowners are realizing that default is not a painless solution. Foreclosure can cause tax liabilities for borrowers who lose their homes. The debt cancelled by foreclosure is a source of income to the defaulting borrower. A gain results when the cancelled debt exceeds the borrower's tax basis in the property. In addition, lenders may become more aggressive about pursuing deficiency judgments against borrowers who default. Starting in late 1986, FHA, FNMA and FHLMC began requiring lenders to report mortgage defaults to credit agencies, making it more difficult for a borrower to obtain another mortgage loan after a foreclosure.

Lenders may become more reluctant to foreclose a loan, choosing to work with the borrower to resolve the problem. Just as there were innovative financial techniques to allow people to buy homes when prices and interest rates were high, there will be new approaches to working out mortgage default problems such as no-cash or short-cash sales. Lenders also realize that concentrations of foreclosed homes can deteriorate neighborhoods and make selling a home difficult. Another source of optimism is that recent borrowers should not experience the drastic reductions in property values that induced earlier buyers, who bought when prices peaked, to abandon their mortgages.

In the short run, however, foreclosures may increase. Both lenders and borrowers could lose their staying power. Lenders are under pressure from regulators to liquidate their non-performing loans. Borrowers may lose their resolve to keep the home if economic conditions do not improve. Unemployed workers may have no choice but to relinquish their homes. Those waiting for a sale could give up the effort as hopeless. A particular problem exists for those who have older mortgages with high interest rates. In many cases, these borrowers are unable to refinance these mortgages, possibly because the property is a condominium or they no longer occupy the home. If refinancing is not possible, these borrowers may determine that default is their better course. Foreclosures will continue to preoccupy real estate finance during 1987, particularly in the energy oriented areas of Texas.

For income-producing property, the new tax law will encourage a return to simpler, more straightforward financing methods. Intricate arrangements intended to produce artificial tax losses or to allocate various tax benefits will be pointless under the new rules. Lender participations also will decline. First, equity participations are less attractive because inflation-induced appreciation has diminished. Second, the new tax law penalizes seller financing. If a lender is forced to foreclose on a loan in which an equity position is held, the resulting foreclosure sale could be construed as seller financing if the lender provides the purchase loan.

With the savings and loan associations increasingly acting as mortgage bankers, some may question the need for a specialized mortgage lender. This development could be the last step in deregulation of lending institutions started in 1980. While individual lenders may specialize in certain types of loans in the future, the choice probably will not be dictated by regulations.

As more Texas banks and thrifts experience trouble, mergers will become more common. Lifting the prohibition against interstate mergers recently eliminated an important obstacle in the path of this trend. The aura of the independent Texan will be further eroded.

HOUSING MARKETS

Despite lower mortgage interest rates, housing market activity declined in 1986. The obvious reason was the state's slowing economy. Fewer new homebuyers are coming into the state, and those who remain are less financially secure. Although housing is an apparent bargain, prospective buyers who are vulnerable to layoffs or decreased income are staying out of the market. This includes first-time buyers as well as owners who want to improve their current housing.

Part of the slowdown may be the result of a trend begun several years ago. Low appreciation rates have convinced some potential buyers that housing is no longer a lucrative investment. Indeed, the market is swamped with houses being unloaded by investors. This change has eliminated some non-traditional buyers such as singles and young couples without children who entered the market in force during the latter 1970s. In addition, some who desire homeownership for its intrinsic benefits may have been scared off by reports of foreclosures and long delays in selling homes. They are wary of becoming trapped in what may prove to be a costly financial mistake. These sentiments are distinctly different from the ideas that prevailed several years ago. If this trend persists, housing market activity may be depressed for many years.

Table 11. Listings and Sales in Texas Multiple Listing Services, 1978-86

Year	New Listings (thousands)	Change (%)	Number of Sales (thousands)	Change (%)	Sales Volume ($ millions)	Change (%)
1978	230.1	22	113.4	16	5,153.4	40
1979	250.8	9	111.1	-2	5,862.6	14
1980	286.3	14	94.1	-15	5,733.0	-2
1981	278.0	-3	83.8	-11	5,735.3	-
1982	292.3	5	74.8	-11	5,577.3	-3
1983	332.0	14	88.8	19	7,422.9	33
1984	362.2	9	89.3	1	7,969.1	7
1985	387.9	7	90.3	1	8,387.8	5
1986*	445.0	15	80.0	-11	7,120.0	-15

*Projected from first three quarters data.
Source: Real Estate Center, Texas A&M University

On a more optimistic note, the sales figures may be higher than reported. The data shown in Table 11 do not include all sales of foreclosed homes. If substantial, these sales may boost activity in many depressed markets. In addition, some buyers may be waiting merely for both prices and rates to decline further. With appreciation and inflation rates low, there is little urgency to buy. Uncertainty over the treatment of homeowner tax benefits under the new tax law may have added to this reluctance. Because homeowner benefits were not eliminated in the law, the market could experience a rebound in 1987.

Table 12. Mean Prices of Homes Sold Through Multiple Listing Services in Texas, 1980-86

Year	Mean Price ($)	Indicated Appreciation (%)
1980	60,771	15
1981	68,908	13
1982	75,184	9
1983	83,549	11
1984	89,231	7
1985	92,895	4
1986*	89,800	-3

*Projected from first three quarters data.
Source: Real Estate Center, Texas A&M University

Average home sales prices as reported by Multiple Listing Services throughout Texas declined in nominal terms for the first time since the Center began compiling records in 1973. Although no statistics are available, many observers believe that reported prices in recent years were inflated by the influence of favorable seller financing. In other words, actual prices in prior years would have been lower than reported if they had been adjusted for cash equivalency of the financing. With the advent of more affordable mortgages from institutional lenders, seller financing is not as prevalent today. Therefore, prices might appear lower because of the loss of financing premiums that had been included earlier in reported prices. In addition, recent statistics have included a number of distress sales in which sellers were willing to make significant price concessions to close a sale. Third, a lower volume of sales makes the average price more sensitive to the mix of homes sold. In other words, a larger proportion of smaller homes may have been sold than in previous years.

Regardless of these limitations in reported data, it is likely that the values of homes have stabilized if not declined throughout much of Texas. Housing demand has stalled at a time when there are ample homes on the market. Because no significant change in economic or market conditions is foreseen, the outlook is for continued flat or slightly lower prices in 1987.

For the first time since 1980, Texas households with average income can afford to purchase the average-priced Texas home. Homeownership is more accessible today because both prices and mortgage interest rates have declined. At the same time, ownership has lost some of its investment appeal because of the anticipated slow rates of appreciation in future years and lower value of tax benefits from lower marginal tax rates in 1987 and 1988. For those who still aspire to homeownership, there has never been a more favorable time in recent years to purchase a home.

Table 13. Housing Affordability Index, Texas and United States, 1977-86

Year	Texas	United States
1977	1.46	1.28
1978	1.35	1.15
1979	1.18	0.99
1980	1.00	0.84
1981	0.82	0.73
1982	0.74	0.76
1983	0.85	0.90
1984	0.83	0.91
1985	0.93	1.03
1986*	1.02	1.04

*As of third quarter.
Source: Real Estate Center, Texas A&M University

Favorable conditions for home purchase may be temporary, however. Institutional lenders are tightening mortgage underwriting procedures that may discourage buyers whose income and available cash are close to the qualifying guidelines. The glut of homes on the market will be absorbed gradually. Mortgage rates could turn upward, and the cost of new homes could go up as developers' expenses rise. With the demise of federal revenue sharing and promised reductions in other federal grants, cities will be forced to raise developers' fees for sewer connections, water taps and utility hook-ups to make up the difference. In addition, developers lost some tax benefits in the new tax law. These costs eventually will find their way into prices for both new and existing homes. **Consequently, 1986 and early 1987 may present a window of opportunity for homebuyers that will not be repeated soon.**

RURAL LAND

Land prices have been flat for the past several years in terms of constant value dollars. With inflation no longer a major concern of investors, the primary demand for land is from users rather than investors. Reports of sales show that many sales are between farmers, often those with adjoining property. The modest advance in prices shown in 1985 reflects sales of a greater than normal portion of high quality land which had not been on the market for many years. The fact that this land was offered for sale in a relatively soft market indicates that land owners are experiencing financial difficulties. Many may also expect lower land prices in 1987.

Consumption buyers are still active and are the major component of the market. Investment demand for land is low because of low inflation rates and poor profits in agriculture. In urban fringe areas, a slowed pace of construction has dampened the demand for land from developers. For direct users, falling prices for farm commodities and minerals are being capitalized into lower land prices. The fall in the value of the dollar relative to other currencies might induce more foreign investment. However, with abundant bargains in developed property in many Texas cities, foreign investors might turn their attention away from the rural land market.

Table 14. Median Price per Acre of Texas Land, 1974-85

Year	Nominal Price ($)	Annual Change (%)	Real Price ($ 1967)	Annual Change (%)
1974	425	21.4	288	9.4
1975	461	8.5	286	-0.6
1976	475	3.0	279	-2.6
1977	513	8.0	283	1.5
1978	576	12.3	295	4.3
1979	625	8.5	287	-2.5
1980	715	14.4	290	0.8
1981	808	13.0	297	2.4
1982	946	17.1	327	10.3
1983	985	4.1	330	0.9
1984	1,000	1.5	323	-2.3
1985	1,050	5.0	325	0.6

Source: Real Estate Center, Texas A&M University

GOVERNMENT POLICY

One of the most important events of the year for those involved with real estate was the overhaul of the federal tax laws. Although real estate investors are becoming accustomed to periodic tinkering with tax rules, this year's sweeping change promises to affect investment approaches radically.

The new law removes nearly all the tax incentives for investment in real estate. Some changes will affect all real estate owners directly, such as the lengthening of depreciable lives and the abolition of capital gains treatment. Other changes constitute a major attack on tax shelters and will affect many popular real estate investments. These include phasing out passive losses (tax benefits emanating from projects which derive income from rent) to offset outside income and subjecting real estate to the at-risk limitations on deductions. Some modifications will have more subtle effects, such as the reduction of marginal tax rates on individuals. These rates will decrease the value of surviving tax deductions, such as mortgage interest and property tax deductions for homeowners.

MAJOR FEATURES OF THE TAX REFORM ACT OF 1986

- Two tax rates; reduced rates for most taxpayers; reduced corporate tax rate
- Increased personal exemptions and standard deduction
- No itemized deductions for sales tax and consumer interest
- Restricted IRAs
- New limitations on tax-exempt bonds, including mortgage revenue bonds
- No favorable treatment for capital gains
- Longer depreciable lives for structures; no accelerated depreciation
- No investment tax credit
- Extension of at-risk rules to real estate investment
- Phased out use of passive investment losses, including all rental property, to shelter outside income

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Source: Jack Friedman, "Tax Reform Act of 1986: Highlights of Provisions that Affect Real Estate," Real Estate Center, 1987.

Essentially, real estate investment of all types, including homeownership, will now be evaluated more on its fundamental economic merits without help from the tax laws. The primary motive of buying a home for housing will be reinforced. With appreciation rates dwindling, home buying for investment reasons has been declining in recent years. Now, much of the tax motivation will be lost as well. Those in the higher income ranges will be the most affected, as their tax benefits have been substantial. Most current homeowners probably will not become renters. However, sale prices for more expensive homes may decline somewhat as tax incentives are reduced. Some economists are predicting higher residential rents as a result of diminished tax benefits for rental property owners (although high vacancies in Texas probably will prevent much passing on of these costs). If rents increase, some moderate income families may be attracted to homeownership which could stimulate lower-cost housing production and broaden the distribution of homeownership in the country.

Income-producing property developed or held primarily for tax purposes will be hard hit. The feasibility of projects that cannot produce a positive before-tax cash flow will be destroyed. Many syndications will have difficulty if they cannot be restructured to supply investor benefits. Those investment vehicles set up to provide diversified portfolios of sound properties will be enhanced, however. The problems of tax-sensitive projects will act as a drag on the values of all real estate for a time, but as the market is thinned, the better projects will emerge as solid investments. Generally rising rental rates will enhance the performance of rental properties. Also expected is a trend toward longer holding periods, corresponding to the longer depreciation schedules and more activity in tax deferred exchanges.

Now that Congress has restructured the tax code significantly, the tax law may remain stable for awhile. Yet there is already talk of further change. Some revisions may be necessary to clear up technical problems with the legislation. However, many expect a push to raise revenues from the new system. Theoretically, the tax reform was revenue neutral, designed to produce the same amount of revenue as the old system. With major revisions in taxpayer incentives, however, revenues will be affected. If tax shelters are flushed out, the new code may produce more revenue, but this hypothesis may never be tested as Congress is under pressure to reduce budget deficits. The expectation is for raising some tax rates in coming years, perhaps adding brackets at higher income levels.

In Texas, the state legislature is on an even more urgent mission of budget balancing. Faced with large declines in tax revenues from the slumping oil industry, the legislature was called into two special sessions in 1986. The short-term emergency was answered with a combination of increased taxes and budget cuts. During the regular session in 1987, the legislature faces the challenge of revamping the state's tax system and expenditures to overcome the expected large revenue shortfall of the next two years.

Although some budget cuts will be significant, new sources of revenue are expected to receive the most attention. The historic resistance to instituting a state income tax probably will prevail, but selected taxes on income may be created. Among the possibilities are extending the sales tax to services and creating an income tax for corporations. A sales tax on services would, in effect, be an income tax on providers of services, such as doctors, lawyers, accountants and real estate agents. Conducting business could become more costly, and the prices of services eventually would be driven up for many consumers.

The bond rating services and investment bankers who underwrite the state's debt issues will watch the legislature's progress closely. The state's credit rating could be downgraded, leading to more costly borrowing. This threat will influence the legislature as it chooses a course of action.

In the past several years, there has been a movement to modify the homestead provision in the state constitution. This provision dates back to the days of the Republic and makes Texas the only state that prohibits discretionary access to home equity. Texas homeowners cannot refinance or mortgage their homes to extract equity except for home improvements or taxes. Proponents of the provision believe the state needs this protection to avoid financial disaster. However, second mortgage programs are growing in other parts of the nation, and there are companies that would like to enter the Texas market.

The movement to amend the homestead provision of the constitution has been unsuccessful, but proponents will try again this year. However, prospects for passage are questionable. First, the legislature will be spending most of its time on the budget. (Proponents are certain to press job creation aspects). Second, there will be added caution because of the state's recent high mortgage foreclosure rate. Third, demand for equity loans has been diminished by the reduction in many owners' home equity and by the decline in interest rates on unsecured consumer loans. However, the federal tax reform may provide some impetus for allowing equity loans in the state. Interest on consumer borrowing is no longer tax deductible under the new law. Mortgage debt, with some limitations, retains its deduction. Therefore, homeowners in other states may keep deductions by converting consumer loans into equity loans. A last minute amendment was added to the tax bill to allow Texas homeowners to take deductions on certain loans, even though they are not truly equity loans. However, the Texas Attorney General has ruled against such loans.

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This publication was funded by appropriations to the Real Estate Center by the Texas Legislature.

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