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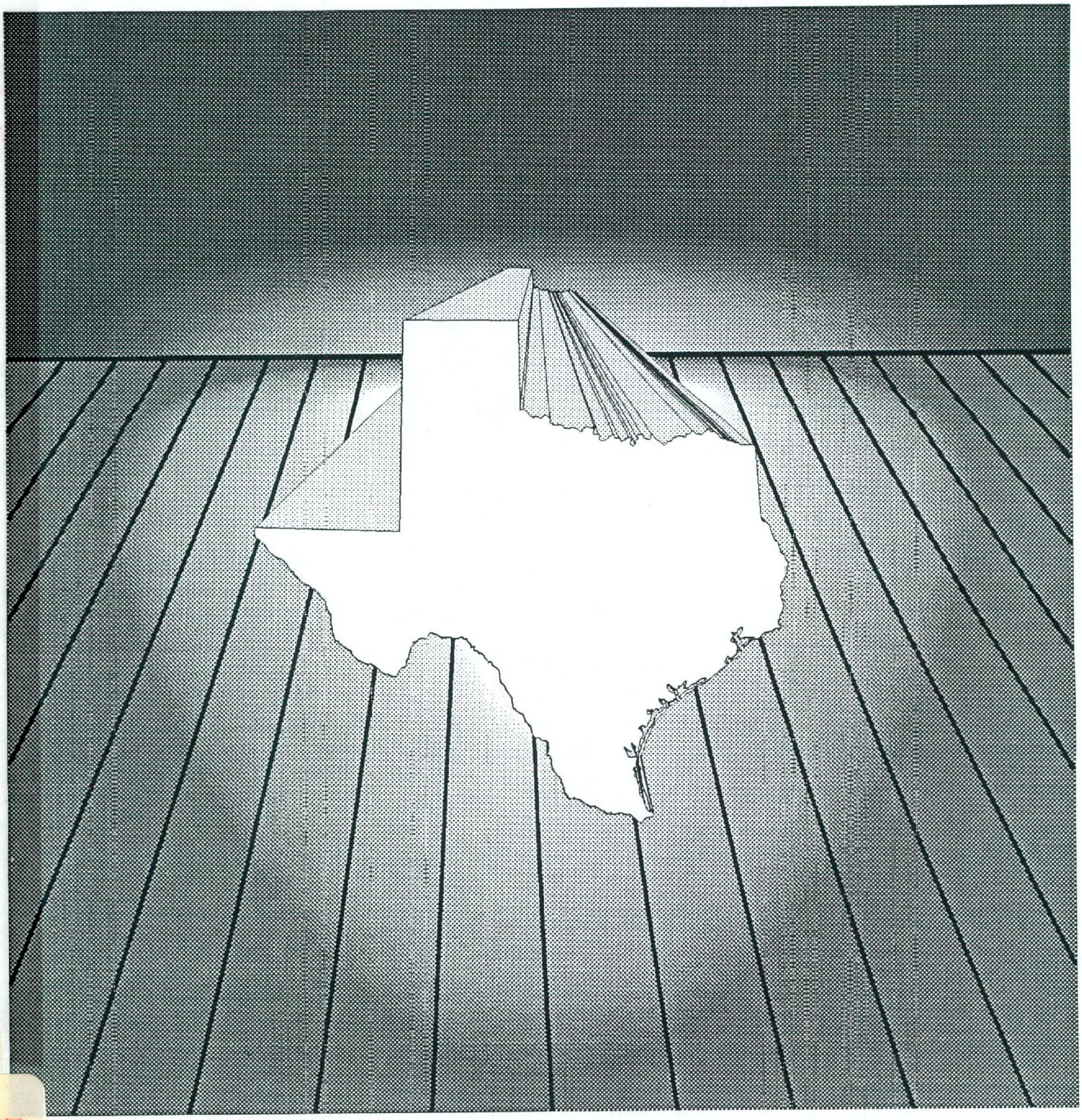
REAL ESTATE CENTER

Real Estate Review and Outlook 1993



Special Report 976

January 1993

Jack C. Harris
Research Economist

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Real Estate Center

Interim Director

Gary W. Maler

The Real Estate Center was created in 1971 by the Texas Legislature and placed at Texas A&M University.

The Center conducts a comprehensive program of research and education to meet the needs of many audiences, including the real estate industry, instructors and the general public.

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Contents

Summary

- The Texas economy is being slowed by sluggish growth in the national economy as well as in foreign markets. Improvement is expected but only if the rest of the country revives. Better markets for petroleum products should help the Texas economy, while defense cuts threaten to dampen the recovery.

- Construction permits continued last year's trend of expanding residential activity. Nonresidential activity is yet to surge despite rent increases. Strong growth in single-family more than offset a weakening multifamily sector. Nonresidential is handicapped by oversupply and restructuring of demand for space. However, retail building is benefiting from restructuring in the way products are marketed.

- Home markets increased in both volume and price. Price increases were indicative of a changing sales distribution toward the higher-priced homes. Under these conditions, volume is being maintained by increased in-migration and the conversion of former rental properties to owner occupied.

- Low interest rates are stimulating mortgage refinancing and home buying, despite some profound changes in lending institutions. Most lenders–even many savings and loans (S&Ls)–are operating as mortgage bankers and are dependent on the secondary market. Some sectors of real estate, such as condominiums, investment properties and construction, are not well served by secondary markets and have had difficulties in obtaining credit.

- Mortgage interest rates are not expected to decline further, despite an extremely steep yield curve. This situation usually leads to rapid increases in short-term rates with long-term rates remaining more stable.

- Rural land markets were hit with uncertainty in 1991, leading to a drop in sales prices after two years of stability.

- The Texas legislature is expected to spend much of its current session searching–once again–for additional revenues. As before, the most likely sources are increases in existing taxes.

- Federal policy should undergo some basic change under a new administration. Efforts to limit the government sponsored enterprises (Federal National Mortgage Association, Federal Home Loan Mortgage Corporation) and the Federal Housing Administration will cease, while some change in capital gains tax rates and passive loss rules could be enacted.

- As in past years, the outlook for real estate markets depends heavily on the national economic outlook. The current economy is undergoing fundamental restructuring, not just moving through a routine business cycle. Significantly, the nation is shifting from a Cold War military power into an international trading partner, and the economy is still trying to sort out the effects of inflation and disinflation of the past 20 years.

- Texas has the advantage of being ahead of the nation in the economic transition. The state faces major problems in maintaining a pro-business climate, assimilating rapidly growing ethnic minorities and successfully accommodating the expected rural-to-urban movement.

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Real Estate Review and Outlook 1993 contains an assessment of the recent past and speculation on the near future from the perspective of the last few months of 1992. The views expressed in this report are those of the Center research staff. In addition, most of the economic information in the narrative is adapted from the work and comments of Jared Hazleton, director of the Texas A&M Center for Business and Economic Analysis. These ideas are offered to help readers plan for 1993.

Review of Recent Trends

National Economy

After a relatively robust first quarter, national economic growth slowed to a crawl in 1992. The economies of Western Europe and Japan also sagged. To add insult to injury, hard times returned to the oil patch as the rig count plunged to record low levels, while corporate restructuring and defense spending cuts continued to take their toll on employment in the Lone Star State.

In Texas, nonfarm employment, personal income and manufacturing output inched ahead, but the gains were small and uneven. The Rio Grande Valley and San Antonio exhibited modest growth, primarily reflecting an improved Mexican economy. Austin finally shook its economic doldrums and began to realize some of its promise as the center for high-tech manufacturing. However, the economies of the state's largest metropolitan areas stagnated, as a sagging energy industry floored Houston, and continued corporate restructuring and defense cuts staggered the Dallas-Fort Worth Metroplex.

In 1993, prospects for a better Texas economy once again will depend on improvements in the nation's rate of economic growth as well as enhanced economic performance in Mexico, Western Europe and Japan. Inflation, as well, must remain under control and interest rates must remain low.

The nation's economic growth this year will be fueled by increased business spending for plants and equipment, continued strength in exports and a modest upturn in consumer spending. Business spending should turn upward in response to low interest rates and improved corporate profits. Exports will rise as the economies of major U.S. trading partners improve, with most of the growth occurring in sales to Mexico, China and Latin America. Consumers have shown not so much a reluctance to spend as a lack of spending money. As incomes gradually

Table 1. Texas Economic Trends and Forecast

		1991	1992	1993*	1994*
Personal income	$ billion	300.4	320.0	339.9	361.0
	% change	5.4	6.5	6.2	6.2
Nonfarm employment	(000)	7,167.4	7,254.2	7,365.0	7,488.5
	% change	1.0	1.2	1.5	1.7
Unemployment (%)		6.6	7.5	6.9	6.4
Oil price ($/barrel)		21.40	20.73	22.25	23.75
Natural gas price ($/mcf)		1.59	1.68	1.83	2.00
Drilling rigs		315	240	264	295

*Forecast values based on forecast U.S. GDP growth of 3 percent in 1993 and 3.1 percent in 1994.

Source: Texas A&M Center for Business and Economic Analysis

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Table 2. Major Employment Centers, Nonagricultural Wage and Salary Employment
(August 1992)

Rank	Major City	Employment		Best Sector	
		(000)	% change*	Name	% change*
1	Houston	1,633.7	-0.5	Government	3.9
2	Dallas	1,372.9	-0.1	Transport	1.9
3	Fort Worth	590.5	0.5	Transport	5.8
4	San Antonio	530.7	1.6	Services	4.8
5	Austin	389.6	1.8	Construction	8.5
6	El Paso	214.7	2.9	Construction	8.0
7	Beaumont	153.9	2.7	Construction	6.0
8	Corpus Christi	136.9	0.6	Services	3.4
9	McAllen	105.4	3.7	Services	4.3
10	Lubbock	97.3	0.7	Government	4.0

*Based on August 1991 to August 1992.
Source: Texas Employment Commission

improve, consumer spending should rise, contributing modestly to increased economic growth.

Interest rates should firm later in the year if the economy begins to show signs of accelerated recovery. The Federal Reserve is concerned about the amount of monetary fuel it gave the economy in 1992 and likely will use any sign of rebound as an opportunity to signal its continued commitment to fighting inflation. If the Federal Reserve is successful, however, in convincing the markets that inflation is likely to remain under control, an improving economy may flatten the yield curve, with short-term rates firming and long-term rates remaining constant or even declining slightly.

Texas should benefit from a recovering energy industry, particularly the natural gas sector, as supply and demand are coming into balance. On the negative side is the expectation for continued corporate restructuring, especially in financial services and petroleum. Additional defense spending reductions are inevitable; the only issue is how much and how fast.[1]

In the long term, Texas' economic fortunes will depend on the state's ability to compete in global markets. The state possesses some strengths as well as several handicaps. The state is fortunate to sit at the gate of the opening Mexican and Latin American markets. Much of Texas is already oriented toward cross-border trade, and these relationships should help if the North American Free Trade Agreement comes to full fruition. The state is a step ahead of much of the nation in the transition from an inflationary economy to one where fundamental productivity determines success. Firms that survived the Texas recession are better prepared to be the low-cost producers that can compete in world markets.

Fortunately, most of the state's liabilities are not inherent but could be overcome through determined effort. Texas always has been proud to be a pro-enterprise state. Yet its reputation as a good place to do business is in jeopardy, largely because of the same policies that have driven business from other states. The search for revenue sources to replace the diminished tax take from oil and gas production has provided the state with high tax rates on sales, business income (franchise tax) and real property. In addition, Texas regulates intrastate trucking so tightly that the costs of shipping goods within the state often greatly exceed those on comparable interstate routes. As a consequence, Texas industries serving local distribution centers are at a disadvantage.

The key to future economic success will be development of human capital–the basic skills and capabilities of residents. Excelling in human potential will be a major challenge to Texas, for much of the incumbent work force is unskilled and poorly educated. The state will need to find ways to make the educational system more effective and productive, as well as more equitably distributed.

Construction

Construction, as evidenced by the dollar volume of building permits issued, continued to improve gradually as it did in 1991. As in the previous year, the small overall gain resulted from a growing residential sector and shrinking nonresidential sector (Table 3). Single-family permits overcame a decline in multifamily activity to post a net gain for the residential sector. Two of the three major segments of nonresidential construction, offices and industrial buildings, continued to fall, while the third–retail stores–sustained the high level of activity reached last year.

Single-family housing was boosted by low mortgage interest rates and increased demand in many of the state's home sales markets. Furthermore, the trend in many markets is toward higher-priced homes for the move-up and relocation markets, thereby stimulating home building targeting this demand.

Multifamily building has been moribund for many years, thanks to federal tax reform, withdrawal of S&Ls as active construction lenders and reduced, but still positive, in-migration of young job-seekers. A revival of sorts began in 1990 when the dollar volume of permits nearly tripled. Yet even this modest surge, compared to the early 1980s when more multifamily units

Table 3. Authorized Construction in Texas

	1990	1991		1992*	
Permits, $ millions			% change		% change
Total	6,258	6,579	+5	6,900	+5
Residential	3,879	4,580	+18	5,200	+14
Single-family	3,652	4,287	+17	4,950	+15
Multifamily	227	293	+29	250	-15
Nonresidential	2,379	1,999	-16	1,700	-15
Hotel-motel	30	51	+70	20	-61
Industrial	321	284	-12	120	-58
Hospital	122	67	-45	170	+154
Office	593	370	-38	350	-5
Education-public	107	76	-29	60	-21
Retail	536	618	+15	620	0
Dwelling Units					
Total	47,195	56	507	+20	59,000
Single-family	38,233	46	209	+21	51,000
Multifamily	8,962	10,298	+15	8.000	-22

*Estimated from first nine months data.

Source: U.S. Census Bureau

were produced than single-family homes, appears to have lost steam during 1992. Although many markets report high occupancy rates for existing apartments, rents have not risen

Table 4. Ten Most Active Texas Markets, 1992*
Residential Authorized Construction

Rank	Area	Dollars (millions)	Percent Change	1991 Rank
1	Dallas	1,590	+18	1
2	Houston	1,140	-11	2
3	Fort Worth	610	+14	3
4	Austin	420	+30	4
5	San Antonio	230	+81	5
6	Galveston	160	+47	6
7	El Paso	130	+34	7
8	Brazoria County	100	+25	8
9	Killeen	80	+122	15
10	McAllen	60	-18	9

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

Table 5. Ten Most Active Texas Markets, 1992*
Nonresidential Authorized Construction

Rank	Area	Dollars (millions)	Percent Change	1991 Rank
1	Houston	390	-13	1
2	Dallas	300	+3	2
3	Fort Worth	170	-7	3
4	San Antonio	90	-41	4
5	Austin	80	-31	6
6	Brazoria County	60	-54	5
7	Laredo	57	+148	14
8	El Paso	55	+24	9
9	McAllen	35	-56	7
10	Galveston	30	-52	8

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

to the point that would justify new projects. With little tax incentive and weak inflation-induced appreciation potential, today's multi-family projects must succeed on operating cash flow. Hence, rental rates and the cost of financing are influential factors.

Most nonresidential markets remain under a burden of excess inventory. While some space has been absorbed, stocks remain ample. For example, Cushman and Wakefield reported improvements in office vacancy rates during 1991. However, at the end of that year, vacancies were still more than 20 percent in: Houston (21.9 central business district [CBD], 24.8 suburbs); Dallas (30.2 CBD, 26.1 suburbs); and San Antonio (34.5 CBD, 25.9 suburbs).

In addition, the demand for real estate space is changing, with both positive and negative impact on construction. Computers and other business technology are decreasing the need for office space. Therefore, absorption has been slow despite rapid growth in the service sector employment. On the other hand, changes in the retailing sector have boosted construction of store building and shopping centers. Emphasis on value and low price has increased the appeal of no frills discount retailing and created the need for new types of sales facilities and outlets. The aggressive expansion plans of some of the state's grocery store chains have added to the demand for new retail facilities.

Hospital construction has had an active year. Permit data indicate major projects were started throughout the state, possibly reflecting the aging population and the expanding health-related service industries.

A few local markets have had remarkable increases in activity. Most areas showed an increase in home building, although Houston's total was decreased by a slowing multifamily sector. The booming housing market in Killeen-Fort Hood reflects the impact of relocating nearly 15,000 troops of the Fifth Mechanized Infantry from Fort Polk. Home sales have multiplied, and construction has followed suit. Laredo has picked up in all sectors as a result of increased international trade. Brazoria County has reported notable increases in office and industrial projects, despite the statewide slump in these sectors. Office construction was active in Lubbock, as well, reflecting strong employment growth during the first half of the year.

Markets

Continued affordability stimulated a moderate increase in home sales. However, the most notable development in housing markets is the rise in average price on sales during the last two years. The increase is the result of rising demand, declining supply and a shift to higher-priced homes that has characterized the market recently. The current market is driven by move-up buyers taking advantage of apparent bargain prices and low mortgage interest rates. Economic uncertainty, as reflected in rising unemployment rates, and tighter mortgage underwriting criteria are restricting the flow of entry-level buyers into the market.

Sale levels have been maintained by two phenomena. First, more people are migrating into the state because of corporate relocations and a relatively favorable employment environment compared to other regions of the country. Often these newcomers have sold homes in areas with higher home prices and seek out the better homes in the Texas market. In addition, move-up buyers are converting their old residences into rental housing in response to the lack of willing buyers. While only 18.3 percent of single-family, detached housing in Texas was renter occupied in 1980, the proportion rose to 31.5 percent according to the 1990 Census.

Existing inventories of homes on the market are being absorbed as sales rise and new listings decline. The ratio of sales to new listings is a good indicator of the balance of supply and demand in the market. A rising sales-to-listings ratio should generate optimism about improved future markets.

Among local markets, Austin continued to achieve record sales levels, similar to the performance of the Houston market in previous years. Houston showed signs of cooling somewhat after several record-breaking years–perhaps finally settling into a normal market. The Dallas-Fort Worth area is coming out of a mild slump with significantly improved sales and higher prices. The Killeen-Fort Hood market is one of the hottest in the state, thanks to large-scale troop relocations mentioned previously.

Although industrial construction has been waning, Texas cities rank high in the most recent Ernst and Young rating of preferred locations for new manufacturing plants. The ratings are based

Table 6. Home Sales in Texas Multiple Listing Services

Year	New Listings		Homes Sold		Mean Price	
	(000)	% change	(000)	% change	$	% change
1982	278.3	+3	69.4	-13	$75,908	+10
1983	319.5	+15	85.5	+23	84,696	+12
1984	358.8	+12	91.4	+7	90,096	+6
1985	384.2	+7	88.0	-4	93,442	+4
1986	416.4	+8	80.8	-8	90,263	-3
1987	385.9	-7	85.1	+5	89,327	-1
1988	327.8	-15	91.2	+7	84,101	-6
1989	282.7	-14	88.0	-4	88,806	+6
1990	282.4	-	95.3	+8	86,697	-2
1991	263.7	-7	96.2	+1	89,800	+4
1992*	255.6	-3	101.1	+5	$93,500	+4

*Projected from first ten months data.

Note: State totals have been tabulated from individually reported MLS figures. To insure consistency, each annual total includes the same set of MLSs rather than merely the total of those reporting for that year.

Source: Real Estate Center at Texas A&M University

Table 7. Most Active Local Multiple Listing Services, Number of Homes Sold, 1992*

1992 Rank	Area	Sales		% change	1991 Rank
		1991	1992*		
1	Houston	32,491	29,700	-9	1
2	Dallas	16,858	19,500	+16	2
3	Austin	7,376	8,400	+14	3
4	San Antonio	6,526	6,700	+3	4
5	El Paso	4,455	4,900	+10	5
6	Northeast Tarrant County	3,728	3,500	-6	6
7	Fort Worth	2,506	3,200	+28	8
8	Arlington	2,741	3,000	+9	7
9	Corpus Christi	1,885	2,500	+33	9
10	Lubbock	1,738	2,100	+15	10

*Estimated from first ten months data.

Source: Real Estate Center at Texas A&M University

on lease rates, labor force characteristics, transportation infrastructure, construction costs and access to markets. The apparently favorable image of Texas among producers is a good sign

Table 8. Highest Priced Local Multiple Listing Services, Average Sales Price, 1992*

1992 Rank	Area	Mean Price		% change	1991 Rank
		1991	1992*		
1	Dallas	$115,100	$118,400	+3	1
2	Northeast Tarrant County	110,300	117,900	+7	2
3	Irving	106,200	110,700	+4	3
4	Austin	94,400	102,800	+9	4
5	Houston	92,200	99,900	+8	5
6	Arlington	85,800	90,800	+6	6
7	San Antonio	79,600	84,100	+6	8
8	Midland	78,200	84,000	+7	10
9	Tyler	75,200	83,500	+11	12
10	El Paso	77,900	80,300	+3	11

*Estimated from first ten months data.

Source: Real Estate Center at Texas A&M University

Table 9. Preferred Locations for New Manufacturing Sites

Rank	City	State
1	Raleigh-Durham	North Carolina
2	**Houston**	Texas
3	Cincinnati	Ohio
4	Charlotte	North Carolina
5	Fresno	California
6	**Austin**	Texas
7	Atlanta	Georgia
8	Salt Lake City	Utah
9	Seattle	Washington
10	**Dallas**	Texas

Source: Ernst and Young

for future demand for all types of real estate, including homes, public facilities and shopping to accommodate the needs of incoming manufacturing employees.

Finance

Mortgage interest rates have been falling steadily for the past year. The result is renewed housing market activity and an increased refinancing of existing home loans. However, some sectors still suffer from a lack of financing, even to the extent that a "credit crunch" exists for real estate projects.

The residential market is increasingly being supplied with credit by the secondary mortgage market. Mortgage pools now hold more than 30 percent of all mortgage debt (Table 10) and have effectively replaced S&Ls as repositories of mortgage loans. In the commercial arena, pension funds have shown more interest in adding real estate to their portfolios in an effort to boost yields.

Real estate continues to appear risky to lenders and investors, given the steep decline in market values in recent years. This aversion to real estate debt is re-enforced by the rules placed on lending institutions by the 1989 Financial Institutions Reform, Recovery and Enforcement Act and the 1991 Federal Deposit Insurance Improvement Act. Lenders are required to set aside a larger percentage of capital for each real estate loan closed than for alternative investments.

Eventually, lenders will be required to reserve capital equal to the entire amount of the loan (by 1994). This requirement reduces the multiplier through which lenders may convert deposits into loans, thereby reducing yields. Therefore, government securities, which provide lower nominal yields but require no capital set-aside, are more profitable. Since 1990, commercial banks have reduced the portion of their portfolios in loans by 5 percentage points in favor of securities. In response to complaints, Congress has agreed to stretch the phase-in to 1996 and to loosen the rules on how much real estate lenders are allowed to carry in their portfolios.

Falling mortgage interest rates have benefited those who can qualify for loans. Current rates are at the level they were before the big run-up in the late 1970s. At the same time, inflation rates are lower than they were at that time. Can interest rates fall further?

The research staff thinks rates will not fall appreciably. The case for lower rates is based on the yield curve: the relationship of security yields and their maturities. During the last year, the curve has steepened significantly, primarily because short-term rates have fallen more than long-term rates (Figure 2). This situation may provide hope that long-term rates will decrease to match the fall in short-term rates.

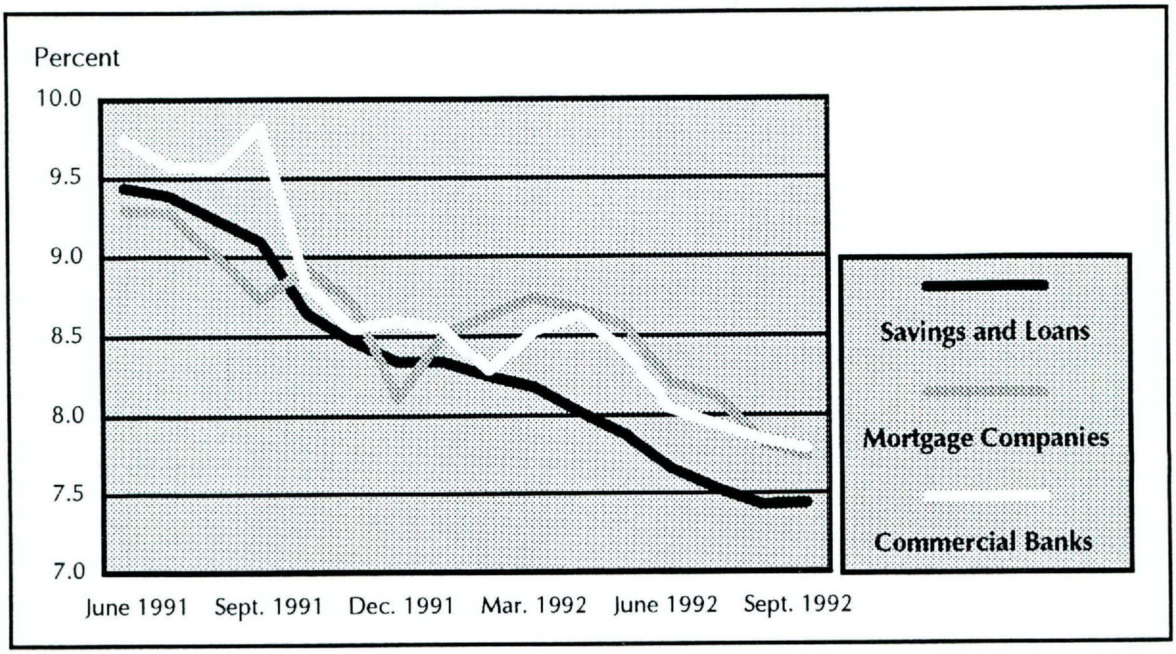
However, this is not what usually happens. More often, short-term rates rise to flatten the curve. The fall in short-term rates is caused by

Table 10. Mortgage Debt Held

	1987	1988	1989	1990	1991
Total ($ billions)	$2,986	$3,270	$3,556	$3,912	$4,026
Percentage of total debt held by					
Commercial banks	19.8	20.6	21.6	21.6	21.6
Savings and Loans	28.8	28.3	25.6	20.5	18.0
Other institutions	8.1	8.3	8.4	8.1	8.1
Agencies	6.5	6.1	5.9	6.4	7.0
Mortgage pools	24.1	24.8	26.6	28.4	30.6
Individuals	13.7	13.0	13.2	16.3	15.9

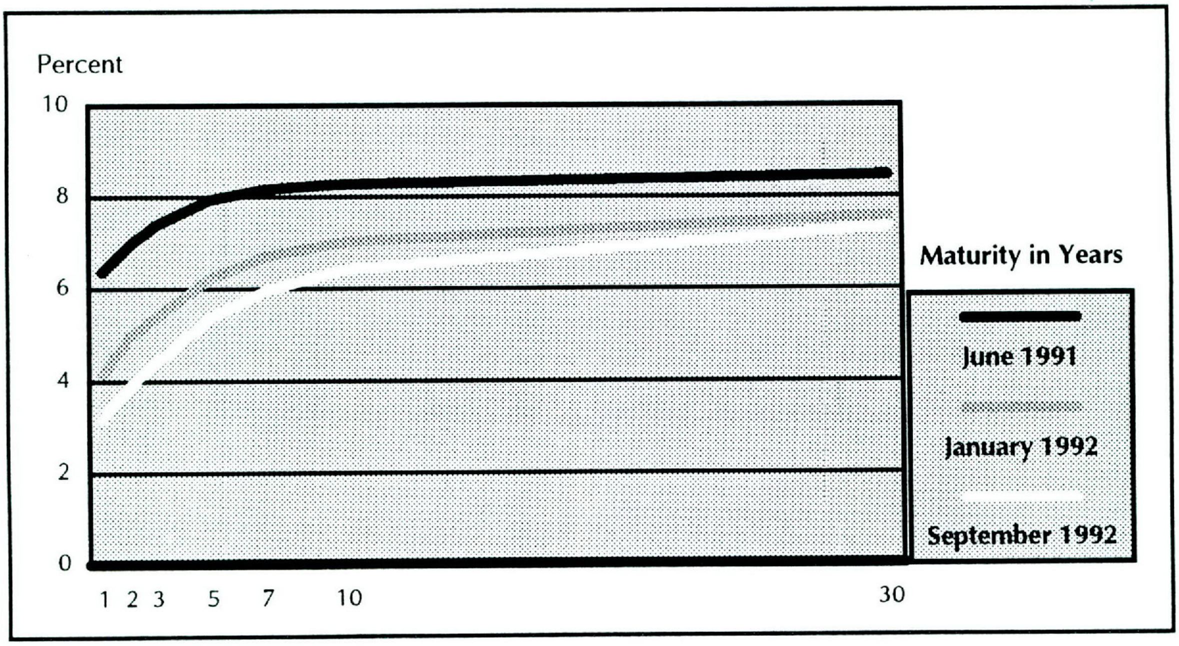
Source: Federal Reserve Bulletin

Figure 1. U.S. Mortgage Rates, Effective Rates on All Loans



Source: Federal Housing Finance Board

Figure 2. Yield Curve Trends, Constant Maturity Treasury Yields



Source: Board of Governors of Federal Reserve System

the Federal Reserve's attempt to stimulate demand and prevent economic recession. Expansive monetary policy risks creating inflation, thus limiting its application, particularly by a Federal Reserve committed to protecting the value of the dollar. As the economy begins to show some life, expect short-term interest rates to increase with moderate pressure on long-term rates.

Now that their numbers have been pared through closings and mergers, the nation's S&Ls are regaining profitability. The head of the federal Office of Thrift Supervision reported that 96 percent of the thrifts operating are profitable and that net income for the first half of 1992 was three times that of one year earlier. Unfortunately, the data are no longer available to separate Texas from this total. However, there is no reason to believe that the state's S&Ls are not among the nation's better institutions. Possibly, their renewed vigor could return the thrifts to prominence in the home mortgage market, but the bulk of their lending would be through mortgage banking operations as opposed to portfolio loans based on deposits.

Rural Land

Despite strengthening Texas land prices from 1989 to 1990, the statewide median price declined 8 percent in 1991. This unanticipated drop reflects several unusual political and economic developments that created widespread uncertainty and dampened an emerging trend toward stability.

The year began with the U.S. embroiled in the Gulf War. Although this conflict was mercifully brief, potential buyers fearing a protracted conflict had abandoned the market. When the war ended, agricultural areas had entered their busy growing season, traditionally slow months for land transactions. A combination of poor crops and weak commodity prices, plus media attention on the so-called recession gripping the U.S. economy, created a lackluster fall buying season. Added to these distractions, growing concerns about water rights, wetlands regulation, endangered species protection and a host of governmental actions perceived as a threat to property rights further dampened demand for land.

In this hostile climate, the statewide median price per acre declined from $650 per acre in 1989-90 to $600 in 1991. After adjusting for inflation, the real median price per acre in 1966 dollars fell from $162 per acre to $143 per acre, a 12 percent decline, and left land prices at their lowest level since land value studies began in 1966. Comparing current nominal median prices with 1966 nominal median prices indicates a compound increase of 5 percent, meaning that the median price rose 5 percent annually on the average during that time. However, adjusting for inflation reveals a real average 1 percent annual loss for the same period. The median tract size remained little changed at 138 acres in 1991 compared to 135 acres in 1990.

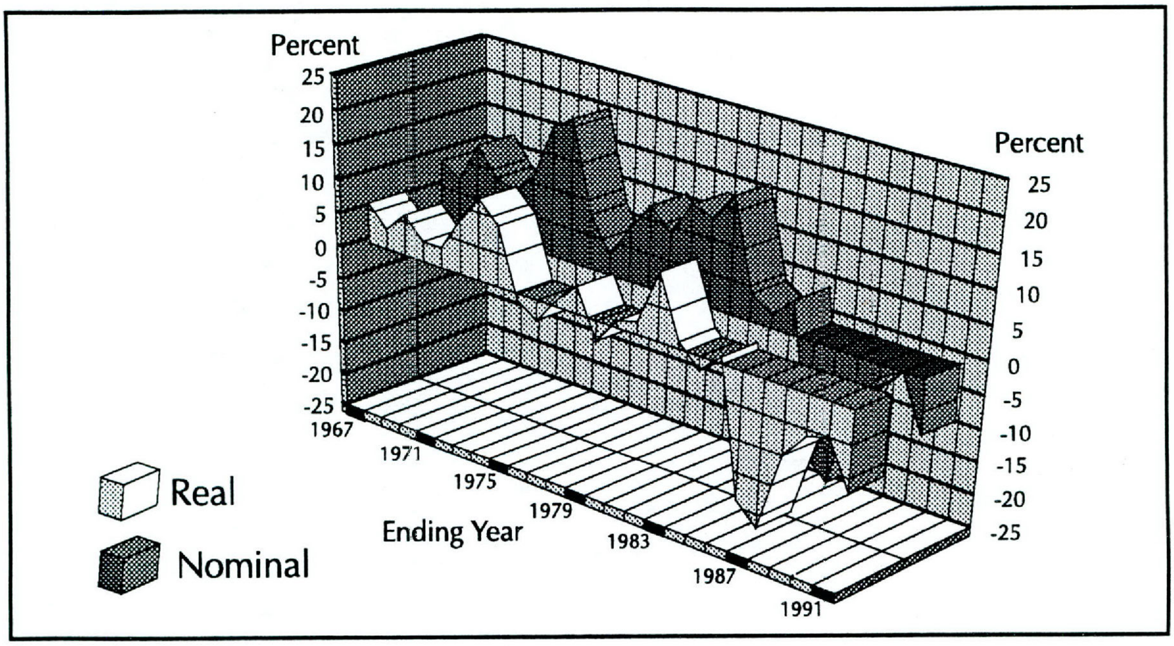
Despite the gruesome statistics, the Texas land market has not consistently lost value. In fact, land markets have progressed through three distinct eras in Texas as Figure 3 discloses. First, both nominal and real prices rose from 1966 through 1974. Then, from 1975-85 the market entered a phase of general stability with nominal prices rising rapidly but with little change in real prices, meaning that the market just kept pace with inflation. Finally, a stage of declining real prices emerged in 1986 and has persisted since then.

These three eras reflect three periods when demand for land underwent fundamental changes. In the era of rising real prices (1966-74), land attracted nonagricultural buyers who desired rural acreage for nonfarming and ranching pursuits. In addition to these users, land also became attractive to investors seeking an effective hedge against emerging inflation. Competing with farmers and ranchers, these groups of buyers supported a rising land market.

During the era of stable real prices (1975-85), nonagricultural users of rural land continued to participate in the market, setting prices that largely ignored agricultural productivity. Declines in the rate of inflation removed the inflation-hedge motivation for land ownership in the early 1980s, prompting investors to turn to the stock market and other investments for higher returns. Still, nonagricultural land users continued to support higher median land prices.

Effects of the oil price decline and federal income tax overhaul of 1986 dampened interest among nonagricultural end users, effectively removing them from the market. Farmers and ranchers once more faced a land market without nonagricultural competing buyers, and prices dropped. Some investors and nonagricultural land users have returned during the past several

Figure 3. Changes in Nominal and Real Prices of Texas Rural Land, 1966-91



Source: Real Estate Center at Texas A&M University

years. However, they have not reappeared in numbers sufficient to end statewide land market declines in 1991.[2]

Public Policy

Although state tax revenues were up by more than 5 percent and total income increased by 12 percent through June of fiscal year 1992, the 1993 legislature will be searching for new revenue sources. State expenditures increased by nearly 15 percent for the period, and funding for court-mandated school reform has yet to be settled. In fact, a shortfall of $5 billion is projected for the next biennium.

Revenue from the once lucrative petroleum extraction taxes continued to dwindle. On the plus side, broadening the franchise tax base brought in a big gain in revenues, and the new lottery has been a significant money-maker. More efforts will be made to increment and broaden the existing tax base. Little political support is apparent for instituting a general income tax, and few public officials are willing to mount a drive for the tax.

The absence of an income tax may have proved an asset in the state's past efforts to lure new businesses. However, extensions of taxes that weigh heavily on business operations, such as the franchise tax, as well as rising property taxes threaten to offset this advantage. In addition, sales and excise taxes are already high relative to other states, and it may be difficult to raise them further.

A renewed effort is underway to modify the homestead law to legalize home equity loans in Texas. Earlier efforts have been unsuccessful, and the unusually high mortgage foreclosure rates of the late 1980s discouraged liberalizing a homeowner's ability to increase debt. Despite lower property values, a large potential market remains among Texas homeowners for equity loans. The odds against reform (requires a constitutional amendment) still are heavy, as significant opposition remains from those concerned with the financial health of the state and its lending institutions.

Federal policy holds special interest because of a new administration with a perceived mandate for change and a large proportion of novice representatives in the Congress. Past efforts to throttle the FHA and the government-sponsored enterprises (Fannie Mae and Freddie Mac), in the interest of reducing risk, have been limited. Much of the recent revision in FHA insurance has been repealed. The outlook is for expansion, rather than contraction, for these and other government housing programs under the Democratic administration.

The prospects for reduced capital gains tax rates may have been improved, but the measure

Table 11. State Revenue by Source, September 1991 through June 1992

	Revenue ($ millions)	Change from last year(%)
Tax collections	13,001.6	5.3
Sales	6,957.4	2.9
Oil and natural gas production	836.0	-26.4
Motor fuels	1,585.7	28.4
Franchise	1,062.5	51.2
Tobacco and alcohol	780.1	-3.4
Other	1,779.6	5.9
Federal income	6,897.9	20.6
Interest and investment	3,362.8	4.0
Licenses and fees	1,543.4	12.9
Lottery (net proceeds)	135.0	-
Other sources	1,369.6	106.3
Total Revenue	26,310.3	12.0

Source: Texas Comptroller of Public Accounts

is likely to be qualified. When limited to certain types of investments, a special capital gains rate could become part of President Clinton's economic stimulation package. Whether real estate will be among the favored assets is questionable, although a case could be made that a slump in real property values is a prime contributor to a slow recovery.

The chances of removing passive loss limitations from real estate income are probably good. Little of the intense, partisan opposition to this issue exists that characterizes other tax revision proposals. A growing realization that the 1986 tax reform may have gone too far in punishing real estate emphasizes that the market has suffered as a result. In addition, based on current depreciation rules, the potential for tax shelter abuse is largely curtailed even without passive loss restrictions. On the other hand, the change could simplify the tax code and allow real estate owners with real losses to receive some tax relief.

The new Congress, in an effort to repudiate much of what they associate with the Reagan era, probably will try to re-regulate business activity and stall efforts at privatization of government services (even though deregulation began under the Carter administration). At the same time, environmental programs will command more immediacy. As a result, the owner of real property will face curtailed benefits and expanded liabilities.

There probably will be more tolerance of high budget deficits to stimulate the economy and experimentation with "new" programs (especially those programs that were nipped by presidential veto in recent years). The Federal Reserve will be hard-pressed to hold inflation to recent levels. Overall, government policies can be expected to provide another turbulent year for real estate markets.

Outlook

Economic recovery, although positive, has been exceedingly slow, despite the Federal Reserve's efforts to keep interest rates low. While the Texas economy began to recover before the nation's, the state's progress has been stalled by the lack of strong markets in the rest of the nation. As was pointed out in last year's outlook, the economy is moving through more than a routine business cycle. Some fundamental changes are taking place, most of which are retarding short-term growth.

The economy is becoming less amenable to government manipulation. Traditional methods of monetary and fiscal stimulus are not as effective nor as predictable as they once were. Frankly, some of the old methods depended on deception for effect. For example, the old Phillips Curve trick of reducing unemployment by inflating the currency depended on consumers thinking that higher nominal income was rising affluence. Likewise, most stimulus methods rely on market participants perceiving government-induced changes as bona fide market signals.

Today, the markets have become more efficient in responding to changes in government policy. Experience has taught the implications of these changes. Furthermore, technology exists to spread information quickly and to effect a quick response. When a change is perceived, the expected results are almost immediately discounted into market prices.

Also limiting the effectiveness of the old fine tuning methods is the increasing globalization of the economy. Low domestic interest rates threaten the supply of foreign capital, the withdrawal of which would tend to counteract the Federal Reserve's infusion of liquidity. Although the United States still commands special status in the world economy, it must weigh the likely consequences of its policies on world markets.[3]

In addition, the government has so many interests that inevitably some policies counteract others. In response to extensive failures at lending institutions caused by nonperforming loans, the government reigned in much of the discretionary freedom offered by deregulation. As a result, lenders were forced to sell assets and reduce their deposit base. Today's downsized, cautious lenders are unwilling or unable to expand their loan portfolios. Therefore, an expansive monetary policy is being thwarted by tight lending policies.

The net result is that considerably more government stimulus is needed to produce the same results. Therefore, no one should be surprised that the economy is not responding vigorously to cheaper credit. But there are other factors weighing on the economy as well.

The end of the Cold War is similar to any post-war period with its characteristic economic lull. The recession is the inevitable withdrawal symptom of an economy being weaned of heavy doses of defense spending. Eventually, the resources freed by reduced spending (the "peace dividend") will result in a restructuring of the economy. For now, much of the dividend has gone into other government spending, such as the S&L insurance fund bailout. Unfortunately, few government programs create as many high-paying jobs as does military spending.

Economic globalization not only constrains government policies but puts pressure on private domestic firms to become more competitive. Unfortunately, many of America's largest companies became overgrown when the domestic market was theirs exclusively. The rise of ferocious competitors from the Far East and Western Europe has forced a great deal of streamlining, often in the form of replacing in-house staff with outside contractors, sometimes referred to as "out sourcing" of tasks. Not only can it be more cost-effective to contract out these jobs, but also it relieves the company of much of the growing liability associated with employees. A not trivial portion of that liability is created when government mandates new benefits and protections for employees. Increasingly, the cost of an American worker is much more than his or her salary, and those costs have to be justified in the employer's decision to hire.

Recovery in the current environment requires bold decision making by entrepreneurs who venture into the new competitive arena. The current mood of the country discourages this kind of risk-taking, however. In part, this attitude has been created by the spectacular failures of recent years, such as the S&L crisis, that painted risk-taking as little more than reckless behavior. Increasingly, *laissez-faire* is perceived as a license to steal rather than as an invitation to innovation. The nadir of deregulation and privatization in this country may have passed, even as it is becoming fashionable in much of the world.

The economy still is laboring under the vestige of inflation-induced decisions of the past. The period of seemingly permanent inflation of the 1970s, along with the disinflation of the 1980s, created most of the economic turmoil of the last two decades. The transition from an economy that rewarded high-leverage financing and inflated the values of tangible assets to the current situation of conservative financing and deflated values has been exceedingly difficult–even though absolutely necessary in the long term. This transition is superimposed on the business cycle in a way that represses any normal recovery.

If this were a normal recession, merely a business cycle down phase without structural change, Texas would be in an advantageous position. The state has worked through most of the excess capacity built up in the early 1980s. Property values have declined to reflect current productivity without much speculative premium. Firms have down-sized to weather the lean years. Even the vast inventory of failed real estate projects held by lending institutions and mortgage agencies has begun to shrink.

Much of the state's economic problems stem from restructuring. Petroleum firms, like most major companies in other fields, continue to shed employees. The state has several major military installations and, therefore, is vulnerable to base closings and personnel reductions.

The hope for resuming vigorous economic growth depends on stabilization of the oil industry, still an important part of Texas' economic base; increased exports, as world economies improve and international trade is enhanced by liberalized trade agreements; and continued relocations of major corporation operations into the state. Signs of better times appear in the form of increased retail trade along the border and the revival of high tech industry in Austin. The state's apparent competitive advantages are its strategic location and relatively low cost structure as a place to do business.

The state must address a number of long-range problems if prosperity is to return.

Business climate. Texas has been a pro-growth, pro-business state, the kind of place that invites entrepreneurship and upward mobility. However, the scramble to replace lost public revenue formerly contributed by petroleum activity has resulted in a tax system that is punitive to business. The belief of elected officials that business does not vote and can be exploited for endless revenue increases is erroneous. Business votes in the most effective way–with its feet. If the Texas tax system is perceived as too onerous compared to surrounding states, attracting new firms will be severely handicapped, and existing businesses will begin to relocate. This is particularly true if public services are not considered of superior quality to justify their price. The same is true of regulations that accomplish little except to protect entrenched interests from competition. In a more competitive world, state government must work harder to deliver valued services at low cost and to weed out inefficiencies.

Ethnic diversity. The Hispanic population of Texas grew twice as fast as the state as a whole during the 1980s. At the end of the next 20 years, no ethnic group will be a majority in the state. Texas is becoming an increasingly multi-cultural region. While such diversity enriches the experience of everyday living, it can create tensions if some groups are achieving economic success while others lag behind.

In addition, the state will require a skilled and educated labor force to attract the best industries and most lucrative jobs. Fully assimilating all ethnic groups into society and providing equal educational opportunities will challenge Texans for the next several decades.

Rural decline. While urban areas decentralize, they are attracting an increasing proportion of the state's population, leaving small rural towns to wither. Agriculture continues to mechanize, becoming less labor intensive. For various reasons, it is less economical to provide modern services at the small scale necessary for rural areas. The jobs of the future will be in the cities. Texas will need to prepare its rural youth to take their place in the urban economy. At the same time, new solutions will be needed to provide adequate water, energy and infrastructure to the urban areas without creating environmental problems common to more densely populated areas of the world.

While the economy may be the most important concern of the real estate community, other factors will affect specific sectors of the industry. The following points should be considered in future plans.

The foreseen **increased agricultural production** may help support higher land prices because of higher yields and incomes. However, the reduced agricultural employment may weaken political support for a continuation of federal farm subsidy programs. This could affect farm land markets to the extent that such support benefits are capitalized into land values.

Apartment markets are tight in many Texas cities. Yet new units have been constructed in only a few areas, and even in those areas, construction of single-family units far exceeds multifamily. The expectation is further tightening in the coming years. The bottom line is higher rental rates. Lenders remain cautious, perceiving apartment projects as risky. Moreover, the lending activity of S&Ls, which were major apartment construction lenders in the 1980s, has been greatly diminished. Equity investors will need higher rents before new projects become feasible, given the limited tax incentives for such investments.

On the other hand, the **expansion of retail facilities** should continue. New types of facilities are needed to accommodate current trends in retail marketing. Outlet and discount malls, superstores that combine food and general merchandise and membership bulk purchase centers are part of this trend. Most retailers prefer new construction to provide the consistent appearance associated with these chains.

As the service sector grows and manufacturing declines, some **services will take on the role of basic industries**. In economic base analysis, basic industries are those local activities that attract money from outside the local market. Traditionally, basic industries have been manufacturing and production of raw materials. The service sector was relegated to merely recirculating this income within the area. However, some services can develop to the scale that their customers extend beyond the local area. For example, a major health care facility, such as those found in Houston and Temple, attracts patients from a wide area. More urban areas are expected to develop such basic service industries in the future as the nation progresses beyond a manufacturing-based economy.

The growth of services industries will **not necessarily translate into greater demand for office space**. In fact, despite growth in recent years, office vacancy rates remain stubbornly high. Many of the expanding services do not require large blocks of centralized space. Nor do they need to locate in central business districts of large cities. With the advent of the cellular telephone and portable computer, service providers may not need offices at all.

More expansion in the computer and petrochemical manufacturing industries is expected in the near future. Areas where this expansion takes place will need new homes and commercial buildings in addition to the facilities used directly in production.

Scale-backs in military facilities and defense-related manufacturers are inevitable. Even if the Republicans had retained the White House, the pressures to reduce budget deficits and the reduced threat of nuclear war dictate reduced spending. The Democrats may hasten the process to create more leeway for increased domestic spending. Politically, it will be easier to reduce spending in districts represented by Republicans now that both the executive and legislative branches are in the hands of the Democrats.

The **real estate brokerage industry has undergone some restructuring** of its own. In many firms, adding new sales associates has less emphasis, and some are moving toward personal assistants ("para-brokers?") to expand the broker's effectiveness. Assistants can handle many of the time-consuming, routine tasks of the sales process. New technology has been incorporated slowly, largely because of the personal nature of brokerage services. This is expected to change as sales agents are asked to provide more services to both principals and buyers.

The year 1992 offered some evidence that Texas real estate is poised to make a comeback. Residential sales were exuberant and sales prices were higher, although largely because of the absence of the entry-level buyer. Construction of single-family homes responded favorably to the brighter market. Mortgage rates are as low as they have been in recent memory. Foreclosures and failing lending institutions are no longer prevalent issues. Possibly these trends will continue into the new year and even expand to other sectors that continue to slumber. However, with the economy pausing in mid-recovery, changes in the factors underlying the demand for real estate and a new set of political priorities being formed in Washington, it is not a time to take the future for granted. The need for visionary, yet flexible, strategic planning remains preeminent.

Notes

[1]The preceding information was taken from *Texas Economic Outlook: 1993 Forecast,* published by the Center for Business and Economic Analysis at Texas A&M University, October 1992.

[2]Charles E. Gilliland, *Texas Rural Land Prices 1991*, technical report 962 (College Station, Texas: Real Estate Center at Texas A&M University, 1992).

[3]Two recent articles support the proposition that government economic policy is not as effective as in the past. In "Monetary vs. Fiscal Policy: New Evidence on an Old Debate," Peter Kretzmer finds that the impact of monetary policy has diminished over the years, yet is still more effective than fiscal policy. Donald Morgan ("Are Bank Loans a Force in Monetary Policy?") points out that one reason for monetary policy's diminished effect is a shortage of capital in lending institutions after years of forced downsizing. Both articles appear in the Federal Reserve Bank of Kansas City's *Economic Review* for the second quarter 1992.

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

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