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benchmarks

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Taxes, Insurance Threaten Affordability

By Jack C. Harris

Low interest rates have brought homeownership within the grasp of almost anyone with a decent credit rating. Those who own their homes have reduced housing costs further by refinancing. Although some of the gains have been dissipated by higher prices, housing by and large has become more affordable.

The Texas Housing Affordability Index (THAI) tracks affordability by comparing the median household income in the state to the income needed to buy a median-priced home. Income needed to buy is determined by applying the criteria mortgage lenders use to qualify borrowers based on their income. A THAI value greater than 1.00 indicates that the median household income is sufficient to qualify households to purchase more than half of the homes sold, if a 20 percent down payment is made. (For a more complete explanation of the THAI, see *Texas Housing Affordability Index: 1989–2001* at http://recenter.tamu.edu/pdf/1592.pdf.)

The chart shows THAI values and mortgage interest rate changes for the past 13 years. Note that THAI values tend to move in the opposite direction of interest rates — that is, when rates fall, affordability improves. From 1998 to 2000, however, the THAI slid much more than was warranted by the rise in interest rates. In fact, THAI levels in recent years are comparable to those of the early 1990s, despite interest rates more than 2 percentage points lower.

Interest rates are only one of the factors affecting affordability. Lenders qualify borrowers by comparing income to the total monthly payment the loan will require. That payment includes principal and interest payments plus contributions to an escrow account used to pay hazard insurance premiums and property taxes. In recent years, escrow contributions have significantly increased the total monthly payment. THAI values are calculated using the total monthly payment. As escrow contributions have risen, index values have been negatively affected.

Rising Escrow Expenses

Property taxes are based on a home's market value. In recent years, demand for housing has been strong, while supply has been somewhat restricted. The result has been a strong sellers market that sent prices rising to such an extent that some observers felt a market "bubble" was developing. Eventually, rising sales prices affect property tax assessments.

But rising property values alone do not cause higher

Table 1. Comparison of Property Tax Rates (Dollars per $100 of Property Value)

Metro Area	1990s*	2002**
Dallas	1.85 (1994)	2.13
San Antonio	1.20 (1995)	2.47
Houston	1.35 (1998)	1.87

*U.S. Census Bureau

**Property tax rates based on revenue and appraisal data reported by the Property Tax Division, Texas Comptroller of Public Accounts. Data represent entire metropolitan area, not just city jurisdiction.

Source: Real Estate Center at Texas A&M University

property taxes. If the tax base is getting larger, local governments can reduce tax rates and collect just as much revenue. However, demands on revenues have been going up as well. School districts are being pressured to meet much of the increased cost of equalizing public school spending across the state.

Equalization is achieved by raising all districts to a minimal spending standard rather than reducing the high spenders to a lower, uniform level. The result is more school spending in the state, with revenues coming primarily from local property taxes. Tax rates are typically increasing despite the gains in the tax base, and homeowners are receiving larger tax bills. Table 1 shows how property tax increases have affected housing costs.

Homeowners are paying more for hazard insurance coverage as well. Insurance companies collect premiums and invest the proceeds until they are needed to pay claims. Generally, a company does well if current claims are approximately equal to premium revenue; earnings come from investment income. But claims have been abnormally high from storms and the "toxic mold" scare. In addition to raising premiums, some companies have reduced risk by raising the criteria for offering new policies and renewing existing policies.

The dismal performance of the stock market in the past three years also has taken a toll on insurance companies' investment returns. Consequently, premiums need to more than offset claim payouts. That means premiums probably would have gone up even without increased claims.

Table 2. 2002 Estimated Rates for Insurance and Property Tax (Dollars per $100 of Property Value)

Area*	Insurance	Property Tax	Escrow Rate
Abilene	.9	2.02	2.92
Amarillo	.7	2.14	2.84
Arlington	.9	2.21	3.11
Austin	.5	1.95	2.45
Bay Area	1.0	2.06	3.06
Beaumont	.9	3.32	4.22
Brazoria	.9	1.90	2.80
Brownsville	.9	2.19	3.09
Bryan-College Station	.5	2.17	2.67
Collin County	.8	1.92	2.72
Corpus Christi	1.1	2.38	3.48
Dallas	1.0	2.13	3.13
Denton	.8	1.78	2.58
El Paso	.6	2.26	2.86
Fort Bend County	.8	2.00	2.80
Fort Worth	.9	2.00	2.90
Galveston	1.0	2.69	3.69
Garland	1.0	2.51	3.51
Harlingen	.9	2.49	3.39
Houston	.8	1.87	2.67
Irving	1.0	1.77	2.77
Killeen	.5	2.70	3.20
Longview	.7	1.90	2.60
Lubbock	1.0	2.05	3.05
Lufkin	.7	1.69	2.39
McAllen	.8	2.08	2.88
Montgomery County	.7	1.72	2.42
Nacogdoches	.7	1.47	2.17
Northeast Tarrant County	.9	2.04	2.94
Odessa-Midland	1.2	2.21	3.41
Palestine	.7	1.56	2.26
Paris	1.0	1.71	2.71
Port Arthur	.9	3.62	4.52
San Angelo	1.2	1.88	3.08
San Antonio	.7	2.47	3.17
Sherman-Denison	1.0	1.66	2.66
Temple	.5	2.20	2.70
Texarkana	1.0	3.21	4.21
Tyler	.7	1.54	2.24
Victoria	.8	1.96	2.76
Wichita Falls	1.11	2.06	3.17

*For definitions of areas, see *Texas Housing Affordability Index: 1989–2001*.
Source: Real Estate Center at Texas A&M University

Adjusting THAI for Escrow Costs

Previously, the THAI used national data on insurance and property taxes to estimate escrow costs. However, a localized benchmark is now used because Texas insurance premiums and property taxes tend to be higher than the national average.

Starting in 2002, THAI includes estimates of insurance premium and tax rates for each jurisdiction covered by the index (the state, most metropolitan areas, some nonmetropolitan cities and subdivisions of metropolitan areas). Insurance rates are based on Texas Department of Insurance guidelines reported by county. Although these rates do not apply to 95 percent of the policies written in the state, they are the only available local rates. They understate actual costs, but do reflect how the rates differ by locality.

Estimating property taxes is more difficult. The Texas Comptroller's Office reports the total appraised property value and tax revenue for each taxing jurisdiction in the state. Unfortunately, these include separate data for each school district, city and special district in the county. Value and revenue, therefore, are aggregated for these jurisdictions to match the boundaries of the area used for each THAI measure. The ratio of revenue to assessed value indicates the effective tax rate for the area. The rates for insurance and property taxes used to calculate 2002 THAI values are shown in Table 2.

Comparable data are not available for previous years. Therefore, an escrow rate was arbitrarily set at 2 percent for all areas prior to 1998. For years 1998 through 2001, rates were graduated evenly up to the 2002 rate as shown in Table 2. For all areas in all years, the monthly payment amount is estimated by multiplying the escrow rate by the median market price and adding that to the principal and interest payment.

Affordability in Near Future

The bottom line is that homes are not as affordable as they might seem from looking at prices and interest rates. Insurance and tax costs have risen enough to nullify much of the benefit of low interest rates. Of course, affordability would worsen if interest rates rise.

Of the four main influences on costs — home prices, interest rates, insurance premiums and property taxes — insurance premiums are the most likely to provide relief for buyers. As the mold scare abates and security markets produce more consistent returns, there should be less urgency for premium increases. In fact, premiums may decline a bit as consumers do more comparison shopping. Home prices could actually decline, or at least not rise as fast as inflation as markets appear to be correcting for the recent "sellers market."

Slower price increases could slow property tax increases, but lower tax rates are highly unlikely. The cost of funding education will continue to go up with few alternative sources of revenue. As more districts bump up against statutory limits on maintenance and operating tax rates, some may repeal the optional homestead exemption, thus increasing the effective tax rate.

Indications are that interest rates have bottomed. The Federal Reserve will begin raising rates when the economy shows signs of recovery. Investment

money should begin flowing out of the bond market as the stock indexes rise. The Fed rate and the stock slump have kept interest rates low for some time, but they may well work in the opposite direction in the future.

Affordability will suffer somewhat in the next several years. However, THAI values remain in the affordable range for most localities and should not decline enough to cause a substantial drop in home sales. ✚

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