The Argument in Favor of MUDs as Currently Constituted In Texas

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In many ways, Municipal Utility Districts (MUDs) in Texas are a unique feature of the division of responsibilities of layered government throughout the United States. However, a comparative analysis among states is only useful for this discussion in that the need for governmental entities such as MUDs relates to how states divide responsibilities and powers among towns, cities, counties, and the state itself. Public facilities must be and are provided at differing levels of government and often in conjunction with varying degrees of involvement by the private sector with varying degrees of public sector supervision. With respect to infrastructure serving residential communities, the issue of "who does what" is a matter of continuing debate resulting in endless variations across the nation.

Even within Texas the need for MUDs or their equivalent is not universal, explaining why their use is mostly concentrated in the Houston metropolitan area and to a lesser extent in the Austin and Dallas/Fort Worth areas. The need arises from a variety of causes: first, relatively weak counties lacking the legal authority and resources to serve new residential development in unincorporated areas; second, the existence of areas outside the corporate limits of cities (within "extraterritorial jurisdictions") where cities are unable or unwilling to expand public facilities beyond their corporate borders; and third, the presence of adequate and reliable ground water supplies in close proximity to these large unincorporated areas which are ideal for serving residential expansion.

Thus, the greater Houston metropolitan region contains large "holes" of undeveloped acreage suitable for new residential development but lack public sector jurisdictional power and authority (or in many cases the risk of speculative development for a city outweighs the potential for economic benefit to its constituents) to provide the necessary public facilities required for residential expansion.

This latter problem is experienced throughout the entire country, where the "presiding" jurisdiction either fails to support residential expansion or takes an unacceptable amount of time to approve such expansion because of fiscal cost-benefit concerns. Even when approval is finally given, it is typically biased towards large industrial, retail and commercial projects or higher priced single-family development in order to provide a higher tax base dividend. In many parts of the U.S. and Texas it can take 2 to 4 times as long as in Houston to get approval for new development due to the time-consuming approval process that can include lengthy political negotiations, including the possibility of a public vote. These delays bear a direct relationship to the cost of housing and do not result in any greater quality of public facilities, recognizing that such facilities in MUDs must meet the same standards as in the neighboring city in the county in which they are located.

In Houston, MUDs provide an efficient and cost effective means to meet the needs of high demand for expanded residential development without dragging the process on or burdening existing jurisdictions and their taxpayers with substantial and speculative added expenditures. Providing for a means of local control to shorten the permit and development processes is one of the many ways MUDs reduce the cost of development (while still providing quality municipal infrastructure) and hence reduce the costs of new homes in Houston's suburbs. For decades now, both analysts and home buyers have been amazed that among the nation's very largest urban areas, Houston has had the lowest cost of new housing. For example, even in smaller urban areas in many parts of the country today, new home prices for comparable housing run close to or over $200 per square foot in contrast to Houston suburban prices of around $125 per square foot. The use of MUDs is the most significant reason why this has been the case.

Thus, in Houston the presence of MUDs is not only in many cases an absolute necessity, it is an efficient way of providing needed infrastructure for expansion without overwhelming existing suburban incorporated areas, and by reducing the bureaucratic costs of lengthy approval processes, providing new housing quickly as needed, which results in reducing the costs of new housing, even during times of high demand.

The question, nonetheless, arises whether there aren't some financial risks associated with MUDs that counterbalance their significant benefits. For those that share some of these concerns one only has to look back at Houston's residential housing crisis of the early to mid-1980s. Bankruptcy of MUDs was a part of that story. The question must be asked, however, was the MUD crises the cause or more simply the effect of the sudden change in fortunes of the region's energy sector.

The energy bust was truly a traumatic economic disaster. In 1981 despite the national recession, Houston was growing so fast that the housing market simply couldn't keep up with the burgeoning demand. Beginning in mid-1982 the pattern had completely reversed. Houston had begun to lose population as it began shedding what would eventually become nearly a quarter million loss in jobs. Thus, it wasn't surprising that newer subdivisions within relatively newer MUDs which had just begun building homes found themselves with an abundance of developed lots on which less than 25% or fewer homes had been constructed. Hence their tax bases were incapable of supporting the bond debt issued to pay off the costs of building the required infrastructure.

The question remains, however, whether the amount of MUD bond defaults during this time period were really the result of a generic flaw in the concept of MUDs or were simply an inevitable consequence of the very sudden change in the region's economic environment that would have had serious economic and financial consequences under any governmental arrangement.

The answer can be found in a variety of facts. First, most MUDs survived the economic disaster of the 1980s quite well, suggesting their fiscal management was solid. Those that struggled were mostly the newest of MUDs that got caught in the sudden reversal from extreme boom to disastrous bust. Second, all of Houston's real estate markets were devastated, most of which had no connection to MUDs and were, in fact, located within Houston and other incorporated municipalities. MUDs had nothing to do with the financial difficulties of the office market in the key commercial centers of Houston, nor with the multifamily residential market bust that devastated virtually every part of Houston. Ironically, the MUD problems of the 1980s where actually rather small compared with the struggles of real estate in general.

Another interesting question is the local financial consequences of the MUD bankruptcies that did occur. Had Houston somehow been able to support suburban expansion without MUDs, what would have been the financial impact upon the City itself? The answer is rather simple. The debt taken on by cities and towns to accommodate the growth of the 1970s would have placed an even greater burden upon those existing jurisdictions in the 1980s, entities that already were struggling with the impact of increased annual expenditures associated with the growth, but with a dramatically lower tax base as real estate prices collapsed. It is hard to imagine what would have happened to Houston's municipal bond rating had it carried all of the debt associated with the growth of the 70s which all of a sudden had to be supported by the greatly reduced tax base of the mid-80s.

Ironically, however, the disaster of the 1980s actually produced a side benefit with respect to MUDs. In response to the experience of the 80s, MUDs began to pursue policies that protected them from the unlikely prospect of another repeat. More responsibility was placed upon the developers themselves, requiring that each new development had to have sold nearly 50% of their lot inventory with at least 40% to 50% of their inventory having tax base enhancing homes already built before MUD bonds could be sold. This is a remarkable game changer. Were such an enormous reversal in the housing market to ever occur again, the vast majority of MUDs would be left with a sufficient tax base to remain viable and honor their bond obligations at reasonable tax rates. This change in policy has also made developers more cautious, making it much less likely that developers and builders will swamp the market with excess lots and homes. If anything, this added caution has produced a modest undersupply of single family lots and housing over the past decade which cushioned Houston's single-family residential market over the past 2 years from the recent dramatic fall in oil prices and employment in the region's energy sector.

Finally, the question arises whether MUDs might be a rather inefficient way to solve the challenges and problems associated with new development. Such a question is comparative by nature. Less efficient than what? From a tax perspective what we do know is that MUD tax rates have been falling since the early 1990s. Because of MUDs, the cost to neighboring incorporated communities has been negligible and the cost (in taxes) to the consumer has been steadily falling. Compare that with the struggle both the City of Houston and Harris County have suffered to maintain a minimal level of public services without raising tax rates. While I am not aware of any statistics that can separate out the portion of city and county taxes attributable to the same type of infrastructure provide by MUDs, what we do know is that these other jurisdictions, and especially the City of Houston, have had difficulty finding sufficient funding to update its old and worn out infrastructure as it is.

It is also the case that the City of Houston, by its very nature, is burdened by a huge labor force to handle its varied responsibilities and as a part of that burden has taken upon itself an enormous amount of unfunded liabilities, much of which is in the form of committed retirement plans. MUDs, on the other hand, are capital rather than labor intensive; have small or no payroll responsibilities; have little or no unfunded pension liabilities; and contract out in a highly competitive market place for the goods and services they need, such as accounting to support their management responsibilities. Thus, it is no surprise that the City of Houston is not particularly interested in assuming the responsibilities of MUDs unless such action would also give them access to high value tax bases such as large retail malls or highly valued industrial properties. <u>If the City of Houston could provide MUD services more efficiently (and hence make a "fiscal" profit), they'd do it</u>.

Texas is a remarkable state in that it operates without an income tax. Yet sales tax rates in Texas are not much greater than many states that do impose an income tax. Thus, it should be no surprise that property tax rates are somewhat higher in Texas than in many states. Yet even this can't be blamed on MUDs. Across Texas property tax rates are not significantly different in areas with MUDs than without MUDs. In fact, there are several hundred Houston area MUDs that have tax rates lower than the tax rate imposed by their neighboring city. For the most part, the distribution of taxes is simply different and as is the duration of the taxes, which historically declines over time. Thus, MUDs carry out an absolutely necessary role in residential developments, especially in the Houston area, in a remarkably efficient manner placing similar burdens on the consumer while greatly reducing the fiscal burden upon regional cities and towns that would otherwise have to fill the need where legally possible.

** Dr. Smith was a senior professor of economics at the University of Houston. He taught and conducted research in urban economics and public finance. He was affiliated with the University of Houston beginning 1973 and previously served as Chairman of UH's Economics Department, and as Director of the Center for Public Policy (CPP). Dr. Smith formed the Institute for Regional Forecasting in the spring of 1999. In 1984, as director of CPP he was among the first to warn real estate developers and homebuilders of the effects of the impending recession facing the Houston economy, which lasted throughout the balance of the decade. Dr. Smith published the Handbook on the Houston Economy in 1986 and has gained local and national recognition for his analyses of the Houston economy and real estate markets. Dr. Smith retired from the University of Houston on August 31, 2010. He resides between his homes in Houston, Texas and Estes Park, Colorado, with his wife, Wendy.*