

# The Nevada Housing Market: Prospects for Recovery

2013

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Southern Nevada Home Builders Association

February 2013

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ECONOMIC RESEARCH  
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2013

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## Executive Summary

Much of the strain on Nevada's economy during the Great Recession came from the burst of the housing bubble. While growing tourism and hospitality has led to some improvement, Nevada is behind a majority of the country in achieving a full economic recovery, mostly the result of weak real estate and construction sectors. This report provides an overview of the Nevada housing market, where it has been, where it is headed, and how current market conditions and builder liability laws are affecting the strength of the recovery.

The Nevada housing market is finally showing signs of recovery. Home prices began rising in 2012. Following a six-year decline, building permits for residential construction were more than 50 percent higher in 2012 than in the previous year. Despite signs of recovery, Nevada housing construction faces several impediments. The inventory of houses in weak hands remains relatively high. In addition, home builders in Nevada face higher regulatory costs than are found in most other areas of the country.

Chapter 40 of the Nevada Revised Statutes, which was conceived to protect homeowners from home defects caused by builders, has had unintended consequences. The term defect is loosely defined, allowing for many lawsuits outside the original intent of the law. Using data from four firms, we find that claims against builders have skyrocketed when we would expect them to be declining. Between 2000 and 2012, new home sales in Nevada decreased by 86 percent while construction defect claims increased by 355 percent. Since 2006, the number of claims per new home in Nevada has been 38 times the national average.

Most construction defect cases are settled outside of court by insurance companies, leading to higher premiums for builders. These settlement costs are increasing in Nevada, while dwindling in other states, even California. According to industry sources, Nevada's premiums are about 85 percent of California's, whereas more competitive western states such as Arizona and Texas have premiums less than half of California's. These escalating costs are then passed onto Nevada consumers in the form of higher home prices. In addition, higher premiums have forced small builders out of the market disproportionately; they have 340 percent more share of the market nationally than in Nevada.

A revision of Chapter 40 would aid in a quicker recovery for the Nevada housing market and overall economy. Reduced costs would lead to increased new home construction. Every new home constructed leads to 3.19 permanent jobs in Nevada. For a \$220,000 home, this generates \$401,790 in total economic activity in the state.

After about six years of sliding, Southern Nevada housing prices are on the rise. Most consider that a good sign. A lack of supply is contributing to the rise, and prices look set to increase over the next few years as the Southern Nevada economy improves. Nonetheless, the overhang of property held in weak hands could dampen any acceleration. In addition, the increase in claims and settlement costs made possible under Chapter 40 may postpone the gains in construction by adding to the costs of new home construction.

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# **The Nevada Housing Market: Prospects for Recovery**

## **1. Introduction**

From 2000 to 2008, Nevada's housing market had never been better. Median home prices increased by 231 percent, and the economy flourished from a general westward movement of the U.S. population and economy. After the housing bubble burst things begin to look much different. Housing prices plummeted, and many Nevadans were underwater in their mortgages. Employment fell dramatically, and foreclosures were at an all-time high. Nevada had it the best and then the worst.

After many tough years, the Nevada housing market is finally showing signs of recovery. Home prices began rising in 2012. Following a six-year decline, building permits for residential construction were more than 50 percent higher in 2012 than in the previous year.

Despite signs of recovery, Nevada housing construction faces several impediments. The inventory of houses in weak hands remains relatively high. In addition, home builders in Nevada face higher regulatory costs than are found in most other areas of the country.

This report provides an overview of the Nevada housing market, where it has been, where it is headed, and how current market conditions and builder liability laws are affecting the strength of the recovery. The next section examines what the housing market means to the Nevada economy. The third section addresses the current status of the housing market and the prospects for a full recovery in the housing market. The fourth section addresses two potential barriers to a full recovery—namely shadow inventory and Chapter 40. The conclusion pulls these threads together to address the outlook for the Nevada home building market.

## **2. What the Housing Market Means to Nevada's Economy**

We take three approaches to examining what the housing market means to the Nevada economy. We consider the role of construction and housing in Nevada's economic base. We use input-output analysis to quantify the impact of home building to the Nevada economy. We also examine the role of the housing market collapse on the Nevada recession.

### **2.1 Nevada's Economic Base**

A region's economic base is determined by which of its sectors export goods or services to other parts of the country. Economists typically measure the sectors forming a region's economic base by using location quotients. A location quotient provides information about

whether the region has more or less of a particular industry than is the national average.<sup>1</sup> With the idea that people across the country generally consume similar items, industries that are present in a region above the national average are expected to export to the rest of the country. These industries have a location quotient greater than one and form the region's economic base.

As shown in Table 1, the industry that most stands out in Southern Nevada is leisure and hospitality. Various aspects of the transportation industry—the result of tourism—also stand out.

**Table 1. Nevada and Las Vegas Location Quotients (2011)**

Industry	Location Quotients	
	Nevada	Las Vegas
Natural Resources and Mining	0.95	0.03
Mining, Except Oil and Gas	6.17	0.15
Construction	1.06	1.05
Manufacturing	0.36	0.26
Trade, Transportation and Utilities	0.95	0.92
Air Transportation	1.45	1.81
Transit and Ground Transportation	3.45	4.56
Scenic and Sightseeing Transportation	4.37	5.72
Support Activities for Transportation	1.08	1.06
Information	0.52	0.53
Financial Activities	0.78	0.81
Real Estate, Rental and Leasing	1.26	1.35
Professional and Business Services	0.90	0.90
Management of Companies and Enterprises	1.05	1.12
Education and Health Services	0.61	0.58
Leisure and Hospitality	2.65	2.98
Arts, Entertainment, and Recreation	1.54	1.34
Accommodation and Food Services	2.83	3.26
Accommodation	12.01	14.16
Food and Drinking Places	1.13	1.23
Other Services	0.71	0.68

Source: U.S. Bureau of Labor Statistics

After tourism-related activities, next come real estate and construction. In 2006, the construction industry also stood out with location quotients of 1.88 and 1.96 in Nevada and Clark County, respectively. Now, both location quotients are close to one.

What is striking about location quotients greater than one for construction and real estate is that construction cannot be exported. To an economist, construction is the result of economic growth rather than the driver. High location quotients in construction and real

---

<sup>1</sup> A location quotient for a given industry in a region is calculated as  $L_{i,j} = (E_{i,j}/E_j)/(E_{i,US}/E_{US})$  where  $E_{i,j}$  represents employment in industry  $i$  in region  $j$ ,  $E_j$  is total employment in region  $j$ , and  $US$  refers to U.S. employment.

estate result from building booms fueled by rapid population growth. High location quotients for construction can only be sustained when the population is growing rapidly.

Over the past 50 years, the United States has seen a general trend of the population and economic activity moving to the West. The resumption of that trend, as the U.S. economy regains its footing, should benefit Nevada construction.

A region's economic growth is largely shaped by its economic base. That base is determined by which of the region's sectors provide goods or services to people from other parts of the country. For Nevada, leisure and hospitality and construction have been the most important components of the economic base. As a tourist destination, Nevada provides leisure and hospitality services to its visitors. The inclusion of construction in the state's economic base reflects the strong pull of people relocating to Nevada. Most other sectors in the Nevada economy go along for the ride.

## **2.2 Quantifying the Economic Impact of New Home Construction in Nevada**

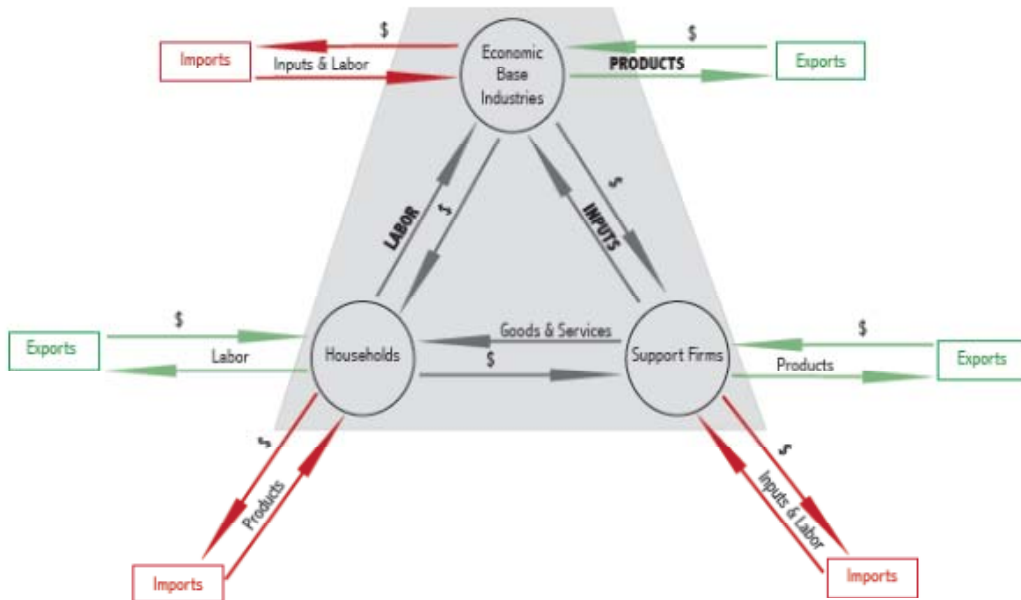
New home construction is important to the Nevada economy. As builders procure the supplies and labor to build a new house, they provide income for others. Those businesses and individuals also purchase goods and services. As the process cascades through the economy these additional spending rounds create multiplier effects, so that the construction of a new \$220,000 home in Nevada generates \$401,790 in total economic activity in the state and 3.19 additional jobs. These estimates reflect multiplier effects, quantified with a Nevada input-output model.

### **2.2.1 Regional Economic Multipliers**

Figure 1 illustrates the major dollar flows of goods and services in any economy. The economic base for a region is made up of the businesses that sell some or all of their goods and services to buyers outside the region. The flow of products into and out of a region is represented by the two arrows in the upper right portion of the figure. To produce the goods and services for "export" outside the region, the basic industry purchases inputs from outside the region, labor from the residents or "households" of the region, and inputs from support firms located within the region. The flow of labor, goods, and services in the region is completed by households using their earnings to purchase goods and services from the region's economic base and supporting industries, and by the supporting firms purchasing goods and services from households and other industries both within the supporting sector and from the export sector. As is evident from the interrelationships shown in the figure, a change in any one segment of a region's economy has reverberations throughout the entire economic system of the region.



Figure 1. Overview of a Regional Economic System



Consider, for instance, the impact of new home construction on economic activity in Nevada. New home construction plays a supporting role in the state by providing dwellings for households throughout the state. In turn, the builders purchase goods and services from households and other support firms in the region. Those firms and households also engage in additional spending. These additional spending rounds create the multiplier effects that are added to the home builder’s direct expenditures to assess the total economic impact on its region.

The total regional economic impact of a company’s operation consists of direct, indirect, and induced impacts. Direct impacts are the expenditures of the firm within the region. The indirect impacts are the additional rounds of spending that result from the firm purchasing goods and services from other firms in the region. The induced impacts are the additional rounds of household spending that occur because the firm hires employees and pays salaries in the region, and those households buy goods and services.

Multiplier effects are reduced as expenditures leak from the region through imports. Multiplier effects are initiated as the region is able to provide exports. Multiplier effects can be sustained over many years but are typically measured over a one- to two-year period.

A support company—such as a home builder—also provides goods and services that facilitate the direct economic activity of other firms within its service region. The direct economic activity facilitated by a support company depends on what percentage of the purchasing firms’ sales is provided by the support companies. The total regional impact of

the facilitated economic activity—such as the businesses and residences supported with electric power—includes the direct, indirect, and induced effects.

### 2.2.2 Quantifying Regional Economic Effects

To quantify the regional economic effects of changes in output produced by a region’s firms, economists use input-output analysis. The structure of an input-output model relates the production in every industry to the inputs it purchases from other industries and from households. In input-output analysis, production in every industry is specified, so that its output and use of inputs scale up or down proportionally.

For a regional economy, the relationship between each of the sectors in a region with  $N$  industries can be described with an input-output matrix as shown in Table 2.

**Table 2. Input-Output Matrix**

Input	Output					
	I	II	III	...	$N$	$H$
I	$a_{11}$	$a_{12}$	$a_{13}$	...	$a_{1n}$	$a_{1h}$
II	$a_{21}$	$a_{22}$	$a_{23}$	...	$a_{2n}$	$a_{2h}$
III	$a_{31}$	$a_{32}$	$a_{33}$	...	$a_{3n}$	$a_{3h}$
⋮	⋮	⋮	⋮		⋮	⋮
$N$	$a_{n1}$	$a_{n2}$	$a_{n3}$	...	$a_{nn}$	$a_{nh}$
$H$	$a_{h1}$	$a_{h2}$	$a_{h3}$		$a_{hh}$	$a_{hh}$

In the matrix, each  $a_{ij}$  represents the purchases that industry  $j$  makes from industry  $i$  for each \$1 of output it produces, each  $a_{hj}$  represents the purchases that industry  $j$  makes from households for each \$1 of output it produces, each  $a_{ih}$  represents the purchases that households make from industry  $i$  for each \$1 of income received, and  $a_{hh}$  represents (unreported) transactions between households. Coefficients such as these also can be used to determine the size of industry  $j$  that is supported by each \$1 of goods supplied to that industry by industry  $i$ .

For a state, such as Nevada, that carries on extensive trade with other regions of the country, some of the purchases made by firms or households go to firms or households outside the region, and the coefficients in any column sum to less than one.<sup>2</sup>

If the first industry is to produce enough output to meet the demand for each of the other industries and households in its region plus the export demand for its output, its production is as follows:

$$x_1 = a_{11}x_1 + a_{12}x_2 + \dots + a_{1n}x_n + a_{1h}x_h + d_1;$$

<sup>2</sup> The sum of coefficients across a row is devoid of economic meaning.

which may be rewritten as:

$$(1 - a_{11})x_1 - a_{12}x_2 - \dots - a_{1n}x_n - a_{1h}x_h = d_1.$$

For the entire set of industries and the households in a region, the output and labor required are as follows:

$$\begin{aligned} (1 - a_{11})x_1 - a_{12}x_2 - \dots - a_{1n}x_n - a_{1h}x_h &= d_1; \\ -a_{21}x_1 + (1 - a_{22})x_2 - \dots - a_{2n}x_n - a_{2h}x_h &= d_2; \\ &\vdots \\ -a_{n1}x_1 - a_{n2}x_2 - \dots + (1 - a_{nn})x_n - a_{nh}x_h &= d_n; \\ -a_{h1}x_1 - a_{h2}x_2 - \dots - a_{hn}x_n + (1 - a_{hh})x_h &= d_h. \end{aligned}$$

These  $n+1$  equations do not tell us how a change in exports from households or an industry would affect the output of all the industries in the region. To quantify these effects, some additional work is necessary. To pursue that work, we place the equations in matrices:

$$\begin{bmatrix} 1 - a_{11} & -a_{12} & \dots & -a_{1n} & -a_{1h} \\ -a_{21} & 1 - a_{22} & \dots & -a_{2n} & -a_{2h} \\ \vdots & \vdots & \ddots & \vdots & \vdots \\ -a_{n1} & -a_{n2} & \dots & 1 - a_{nn} & -a_{nh} \\ -a_{h1} & -a_{h2} & \dots & -a_{hn} & 1 - a_{hh} \end{bmatrix} \begin{bmatrix} x_1 \\ x_2 \\ \vdots \\ x_n \\ x_h \end{bmatrix} = \begin{bmatrix} d_1 \\ d_2 \\ \vdots \\ d_n \\ d_h \end{bmatrix}$$

Recognizing that the matrix on the left is an identity matrix minus the original input-output table, the relationship between production in each of the industries and the final demands can be rewritten in matrix notation as follows:

$$(I - A)X = D$$

where  $I$  is the identity matrix,  $A$  is the original set of input output coefficients,  $X$  is the vector of industry output, and  $D$  is the export demand for the region.

For a given change in the export demand from a region, the complete change in each industry's output and household income in the region can be found as follows:

$$\bar{X} = (I - A)^{-1}D$$

where  $\bar{X}$  is a vector of the production in each sector that results from the region's export demand.

### 2.2.3 Single-Industry Multiplier Effects

Multiplier effects for a single industry are found by specifying a change in the exogenous demand for output from that industry. The input-output relationships are used to quantify the additional spending rounds that yield increased output in every industry. The sum of the change in final demand plus the additional output in each industry that results from the spending rounds is divided by the change in final demand to yield the multiplier effect:

$$Multiplier = \left( \sum_{i=1}^n \overline{\Delta x_i} + \overline{\Delta x_h} + \Delta d_j \right) / \Delta d_j.$$

Such multipliers can be used to quantify the economic impact of firms in a particular industry or of individual construction projects.

### 2.2.4 Quantifying the Economic Impact of New Home Construction in Nevada

To quantify the economic impact of new home construction in Nevada, we employ RIMS II, an input-output model developed by the U.S. Bureau of Economic Analysis. The RIMS II input-output model takes into account the numerous complex interactions in an economy that flow from the initial spending to create indirect and induced effects. The model allows us to calculate the output, compensation, and employment in Nevada that result from the construction and sale of a new home.

As shown in Table 3, the construction of a \$220,000 home in Nevada generates \$401,790 in total output for Nevada, for a multiplier effect of 1.83. The new home construction also generates an increase in total labor compensation of \$120,056 and 3.19 new jobs. Of those jobs, 1.68 are the direct result of the new home’s construction and sale. Larger or smaller homebuilding projects would generally yield results that can be scaled up or down proportionally.

**Table 3. Economic Impact of Building a \$220,000 Home in Nevada**

	<b>Output</b>	<b>Labor Compensation</b>	<b>Employment</b>
Direct Effects	\$220,000	\$67,736	1.68 jobs
Total Effects	\$401,790	\$120,056	3.19 jobs
Multiplier:	1.83	1.77	1.90

## 2.3 The Housing Collapse in the West

The housing market collapse was one of the major contributors to falling employment in the West. In addition, slow national economic growth and homeowners with negative

equity throughout the nation slowed the population shift from the Northeast and Midwest to the West. Together these factors shifted the western states' economies from the familiar position of leading economic growth to the unfamiliar position of leading the decline.

As shown in Table 4, Nevada's construction sector has not performed nearly as well as its national counterpart since the prerecession peak. Had this sector performed as well as its national counterpart during the recession and recovery, it would account for an additional 54,600 jobs in Nevada. Allowing for multiplier effects yields an additional 52,416 jobs statewide, for a total of about 107,016.

<b>Table 4. Percent Change in Employment (Prerecession Peak to Present)</b>		
<b>Industry</b>	<b>United States</b>	<b>Nevada</b>
<b>Total Nonfarm Employment</b>	-3.02	-11.21
Natural Resources and Mining	11.66	35.00
Construction	-28.63*	-66.33*
Manufacturing	-12.89	-24.19
Trade, Transportation and Public Utilities	-4.38	-5.90
Information Services	-12.93	-16.99
Financial Activities	-5.52	-17.06
Professional and Business Services	0.02	-10.41
Education and Health Services	9.93	16.29
Leisure and Hospitality	1.33	-4.87
Other Private Services	-2.26	-8.82
Government	-1.85	-6.50

Source: U.S. Bureau of Labor Statistics and authors' calculations  
 \*As measured from own peak in 2006

With 107,016 additional jobs, Nevada's employment would be about 1,255,216, which is only 2.9 percent below the state's prerecession peak employment of 1,293,100. These figures suggest that the deep recession and slow economic growth in Nevada are largely the result of weakness in the state's construction sector. Had this sector achieved the same performance as its national counterpart, Nevada would be seeing a stronger economic performance.

Hence, we can attribute much of the weakness of the Nevada economy to the interruption of the great westward movement caused by the U.S. recession and to the overbuilding that occurred in Nevada during the nation's 2000-07 real estate boom. Since 2007, Nevada's construction sector has been hampered by slow population growth and a sizable surplus of housing and commercial space.

**3. Outlook for the Nevada Housing Market**

The good news is that Nevada's economy has been improving, albeit slowly. As might be expected, much of the strength is coming from the tourism, gaming, and hospitality sectors. Construction continues to show signs of coming off the bottom.

The bad news is that the slowdown in the U.S. economy, the European recession, and the slowdown in the Asian economies have made themselves evident as slower growth in tourism, gaming, and hospitality. Nevada continues to see financial headwinds, and its real estate markets have a long way to go before the state sees a strong recovery in construction.

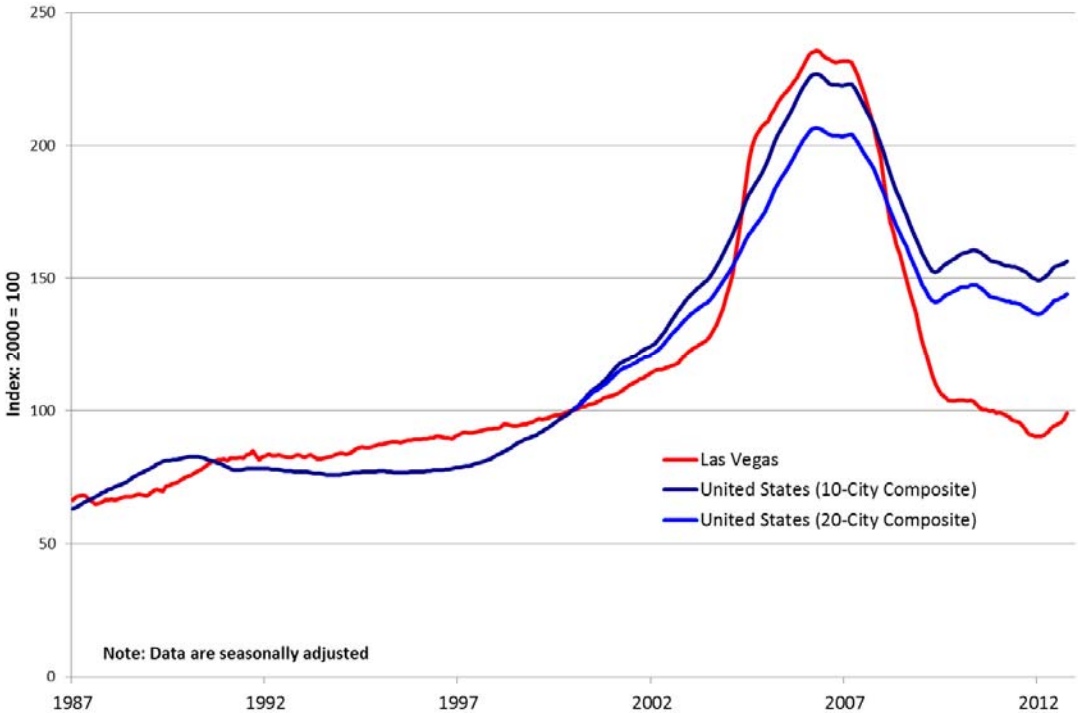
As the U.S. economy accelerates and economic conditions improve in the West, we can expect to see renewed vigor in the Nevada economy. Such an acceleration is not likely to occur until the second half of 2013.

### 3.1 Current Status of the Nevada Housing Market

According to the Case-Shiller index, housing prices in the Las Vegas metropolitan area and the United States both hit bottom in January 2012 (Chart 1).<sup>3</sup> Las Vegas house prices have risen by 9.6 percent since then. U.S. housing prices have risen only 5.4 percent.

The big difference was in the decline. Las Vegas housing prices fell by 61.1 percent from January 2007 to January 2012. During that period of time, U.S. housing prices fell by only 32.9 percent.

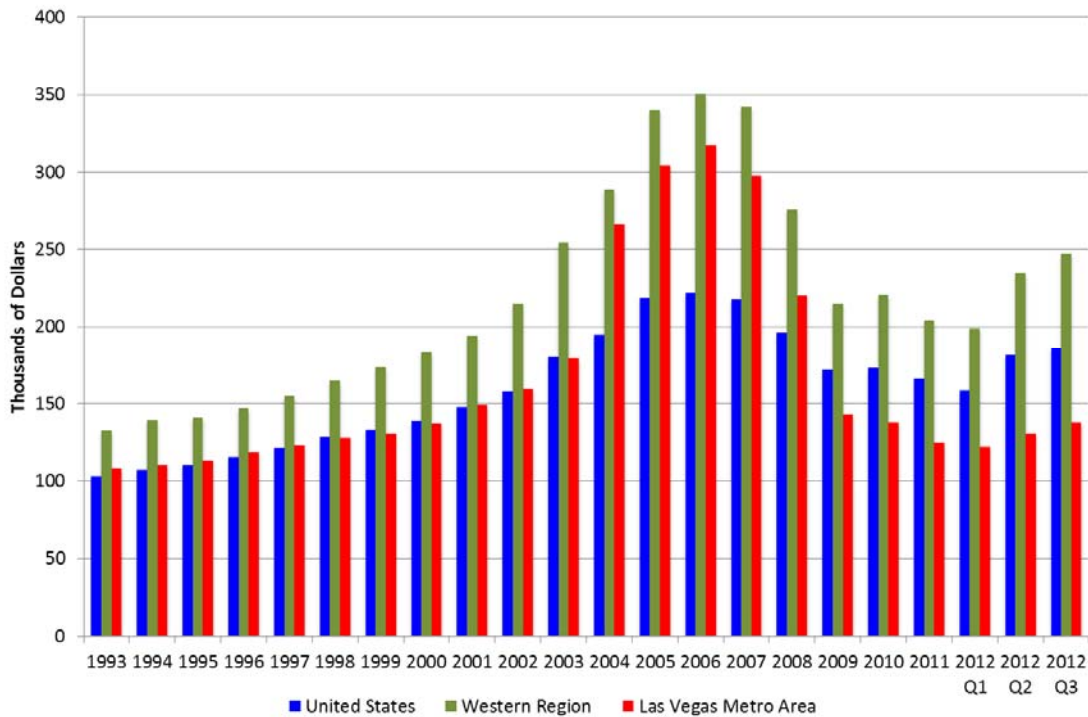
**Chart 1: Case-Shiller Home Price Indexes**



<sup>3</sup> The Case-Shiller index is considered one of the better measures of housing prices because it uses prices from repeat sales, which more accurately captures quality than a more commonly used measure, such as median home prices.

As shown in Chart 2, the nationwide housing boom took Las Vegas housing prices upward by 231.0 percent from 2000 to 2006. Over that same period, housing prices throughout the West rose by 91.5 percent, and U.S. housing prices rose by 60.0 percent.

**Chart 2: Median Home Prices**



Source: National Association of Realtors

The decline in housing prices also was dramatic in Nevada. In third quarter 2012, housing prices in Las Vegas were about where they were in 2000. For the West as a whole, housing prices were 35.2 percent higher in third quarter 2012 than in 2000. For the United States as a whole, the comparable figure was 33.9 percent.

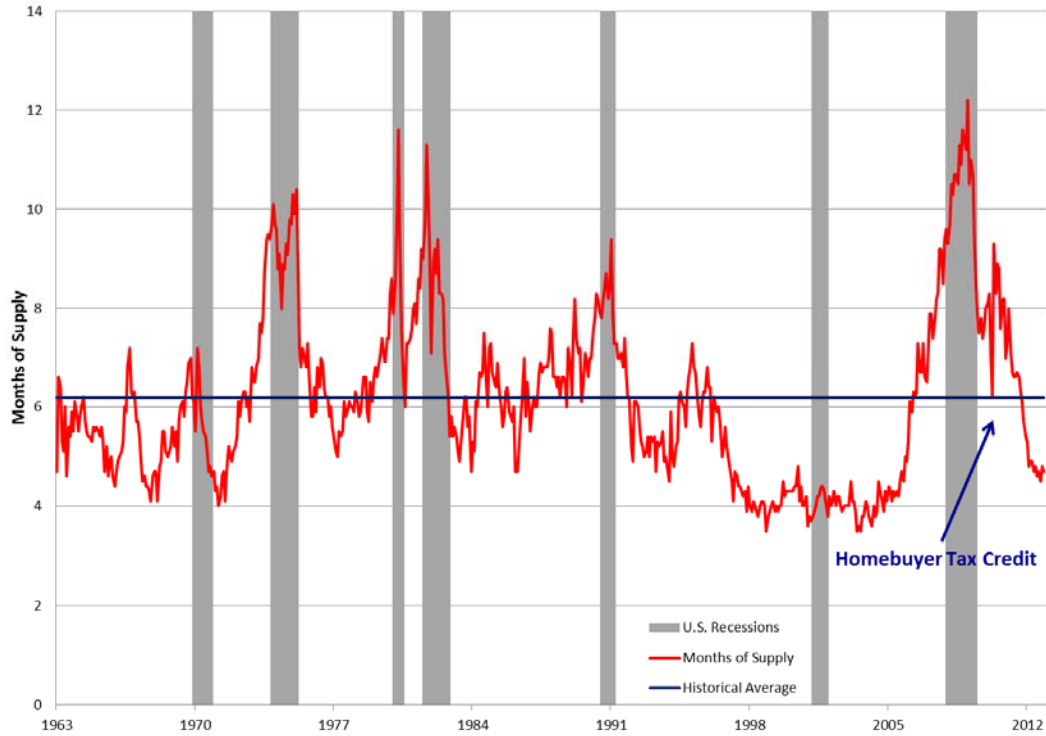
In addition, median prices for existing homes in Clark County dropped more than those for new homes during the decline. They also rose much more sharply in recent months. Prices for new homes are tethered by construction costs, but prices for existing homes are not.

### 3.2 Prospects for a Housing Market Recovery

The timing of the recovery in the Las Vegas housing market matches that of the U.S. housing market. The U.S. housing market is coming into balance (Chart 3). Based on recent sales, the current houses listed on the U.S. market provide only about 4.5 months of supply, which is well below the historic average of 6.2 months. Back in April 2010, the homebuyer tax credit temporarily pushed the supply of houses down to 6.2 months. Nothing similar is

at work today. We are seeing market-driven declines in the supply of houses, which suggest that home prices are likely to continue rising nationwide.

**Chart 3: U.S. Housing Market Tightening**



Sources: U.S. Census Bureau; National Bureau of Economic Research

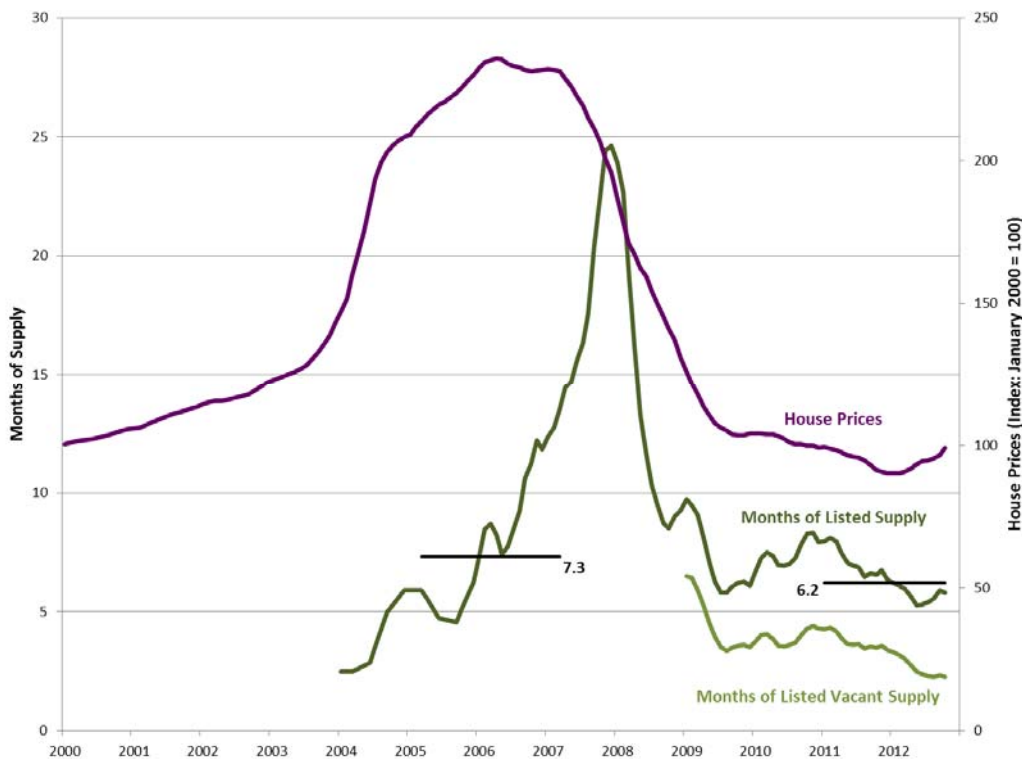
### 3.3 The Nevada Housing Market Recovery

A lack of available supply also is pushing up prices for single-family homes in Las Vegas. For listed homes, the months of supply is down to 5.6 (Chart 4). The decline is coming from a lack of listings. In addition, only 38.3 percent of the listings are vacant. Prices began rising in Las Vegas when the months of supply fell below 6.2. In 2006, prices didn't begin slipping until months of supply rose above 7.3. Probably, the built-up momentum carried Las Vegas home prices upward even after excess supplies were becoming evident.

Although we are seeing some gains in residential construction, builders aren't yet rushing into the Las Vegas market. Despite recent gains, prices for existing homes are below construction costs. Prices for existing homes probably need to rise about 25 percent from current levels before homebuyers find new homes much more attractive than existing homes.



**Chart 4: Las Vegas Months of Supply and House Prices**



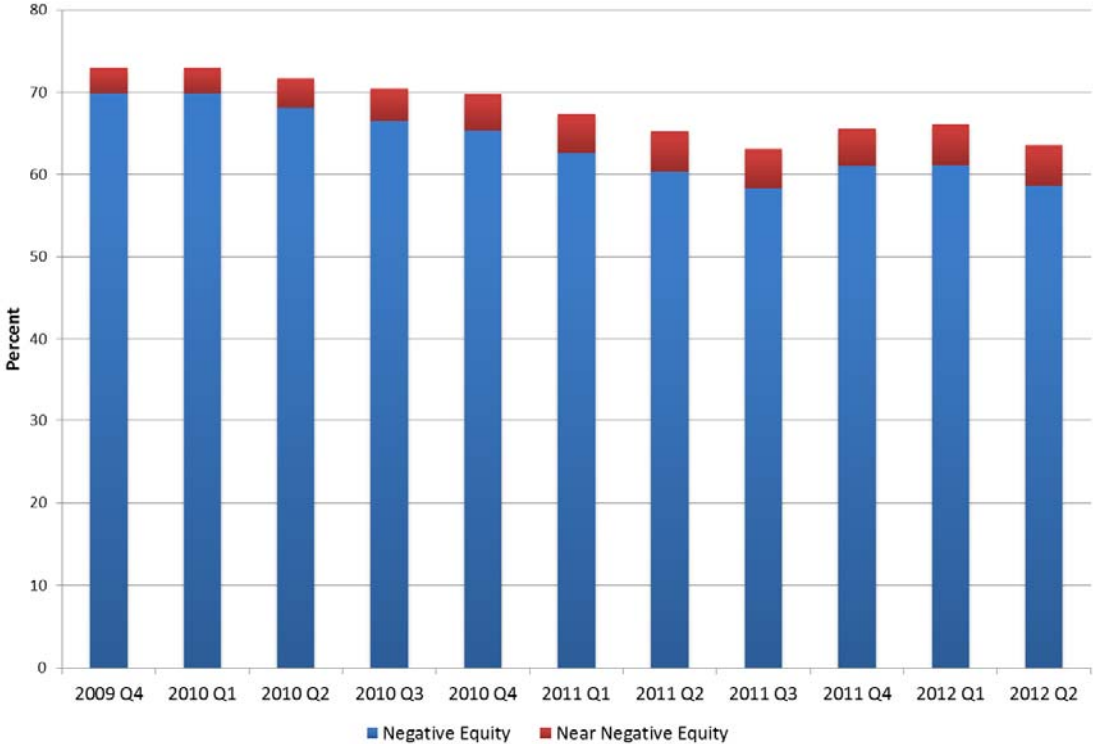
Sources: Standard & Poor's; Greater Las Vegas Association of Realtors; Residential Resources; National Association of Realtors; Center for Business and Economic Research, UNLV

Many Nevada homeowners still have negative equity. As of second quarter 2012, 58.6 percent had negative equity (Chart 5). Another 5.0 percent were close to a negative equity position. These developments represent a slight improvement over first quarter 2012. In that quarter, 61.2 percent of the homeowners in Nevada had negative equity, and another 4.9 percent were close to a negative equity position.

At more than 2½ times the national average of 22.3 percent, Nevada remains the state with the highest percentage of homeowners in a negative equity position. Other states rounding out the top six include Florida, Arizona, Georgia, Michigan, and California at 42.7 percent, 39.7 percent, 35.8 percent, 32.8 percent, and 29.0 percent, respectively.

At the national level, delinquencies on real estate loans are falling, which is an indication that we are seeing a resolution of the national real estate crisis. The improvements are concentrated in commercial real estate, however. There will have to be improvements in Nevadans' equity before a full recovery.

**Chart 5: Nevada Homeowners with Negative Equity**

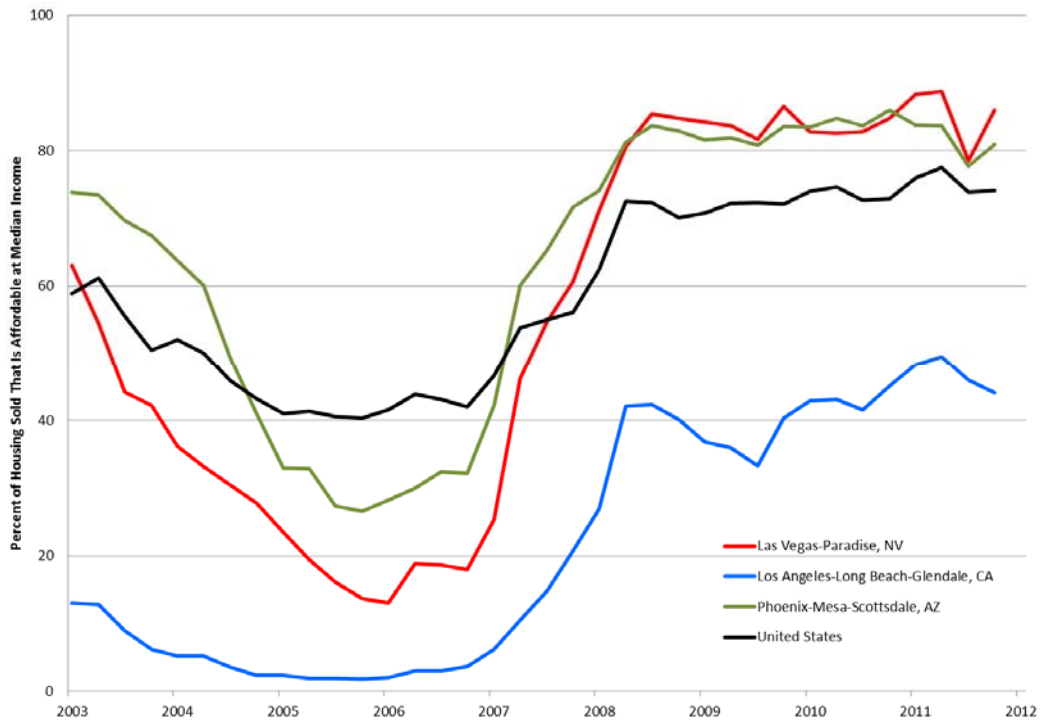


Source: CoreLogic®

Low housing prices can help foster Nevada’s economic recovery. According to the Housing Opportunity Index, which considers both price and income, Las Vegas housing is more affordable than the national average (Chart 6). In the 1990s and early 2000s, Las Vegas had housing that was quite affordable by national standards—which helped propel its growth. By 2006, Las Vegas lost that advantage.

Although we tend to think of low housing prices as indicative of a depressed market, low housing prices will help the Nevada economy grow. Affordable housing is one of the primary reasons that many long-term forecasts show strong population gains for the region, some of which are driven by projected retirements.

**Chart 6: Housing Opportunity Index**



Source: National Association of Home Builders

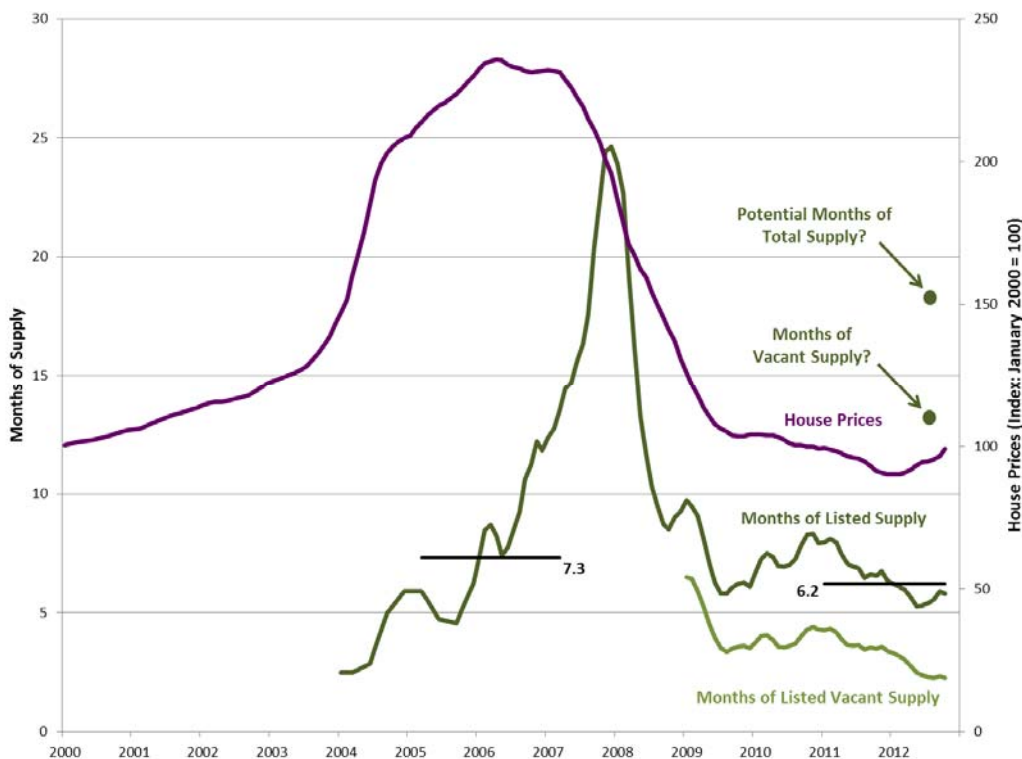
## 4. Obstacles to Recovery

Although Nevada's housing market is beginning to show early signs of life, there are still potential barriers to a full recovery. In this section we address those obstacles and possible solutions to further accelerate growth in the housing market and Nevada's economy.

### 4.1 Excess Housing Supply

In section 3.3, we examined how a low supply of houses has driven home prices upward. Many people remain concerned about a shadow inventory that continues to overhang the Las Vegas housing market. Figures from Clark County Comprehensive Planning place the months of supply of vacant homes—including listed and unlisted homes—at 14.7. Add to that homes in foreclosure and homeowners who are in arrears on their mortgages, and the potential months of supply are about 20 (Chart 7). With banks taking an orderly approach to foreclosure, however, these excess supplies seem more likely to be dribbled rather than flooded onto the market.

**Chart 7: Las Vegas Months of Supply and House Prices**



Sources: Standard & Poor's; Greater Las Vegas Association of Realtors; Residential Resources; National Association of Realtors; Center for Business and Economic Research, UNLV

## 4.2 Chapter 40

An additional barrier to a quick recovery of the Nevada housing market is Chapter 40, a law passed in the mid-1990s. The main purpose of Chapter 40 is to protect homeowners, allowing them to take action against a builder if their home has construction defects.

Although conceived with good intentions, the bill has had some unintended consequences. One problem with Chapter 40 is that a construction defect is not well defined. This has led to many lawsuits about nonthreatening imperfections common in any home, outside of the original intent of the law.

Most of these suits are settled outside of court by insurance companies. This, in turn, has caused premiums to rise for builders, forcing them to either raise prices or, more commonly, go out of business.

### 4.2.1 Chapter 40 Language

Before proceeding, a quick examination of Chapter 40 is needed. From the Nevada Revised Statutes (NRS), the main two passages addressed in this analysis are:

**“NRS 40.640 Liability of contractor.** In a claim to recover damages resulting from a constructional defect, a contractor is liable for the contractor’s acts or omissions or the acts or omissions of the contractor’s agents, employees or subcontractors and is not liable for any damages caused by:

1. The acts or omissions of a person other than the contractor or the contractor’s agent, employee or subcontractor;
2. The failure of a person other than the contractor or the contractor’s agent, employee or subcontractor to take reasonable action to reduce the damages or maintain the residence;
3. Normal wear, tear or deterioration;
4. Normal shrinkage, swelling, expansion or settlement; or
5. Any constructional defect disclosed to an owner before the owner’s purchase of the residence, if the disclosure was provided in language that is understandable and was written in underlined and boldfaced type with capital letters.

(Added to NRS by 1995, 2540; A 1997, 2718)”

**“NRS 40.615 ‘Constructional defect’ defined.** ‘Constructional defect’ means a defect in the design, construction, manufacture, repair or landscaping of a new residence, of an alteration of or addition to an existing residence, or of an appurtenance and includes, without limitation, the design, construction, manufacture, repair or landscaping of a new residence, of an alteration of or addition to an existing residence, or of an appurtenance:

1. Which is done in violation of law, including, without limitation, in violation of local codes or ordinances;
2. Which proximately causes physical damage to the residence, an appurtenance or the real property to which the residence or appurtenance is affixed;

3. Which is not completed in a good and workmanlike manner in accordance with the generally accepted standard of care in the industry for that type of design, construction, manufacture, repair or landscaping; or
4. Which presents an unreasonable risk of injury to a person or property.  
(Added to NRS by 1995, 2539; A 2003, 2041)”

The language in which a constructional defect is defined in NRS 40.615, specifically point number three, allows for a variety of lawsuits outside the realm of actual negligence.

#### 4.2.2 The Effects of Chapter 40 on Nevada’s Housing Market

To illustrate the effects of Chapter 40 on Nevada’s housing market, we collected data from 2000 to 2012 from four different firms, some of which operate in multiple states. We concentrate on three variables: number of closings, number of claims, and settlement costs on an annual basis.

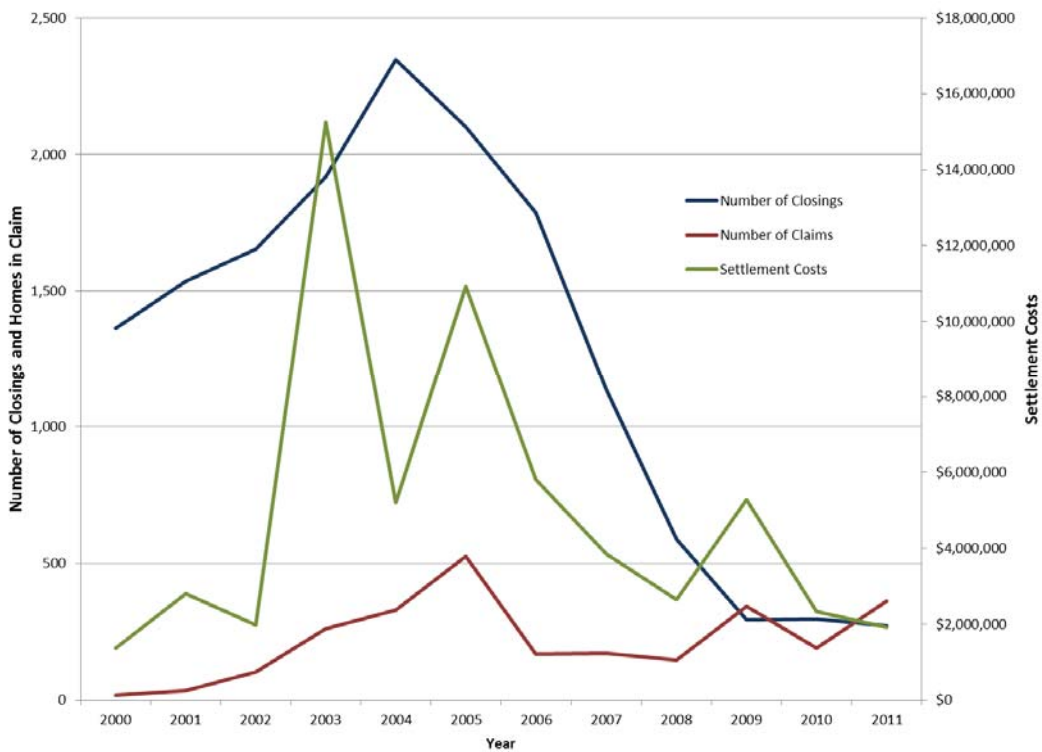
To start, consider the data for Nevada only. As shown in Chart 8, the number of closings dropped by 86.0 percent in Nevada since the peak. In this same time period, the number of claims and the costs of settlements increased by 355.0 and 80.0 percent, respectively.

**Chart 8: Closings, Claims, and Settlement Costs in Nevada**



Compare this to California (Chart 9), which has a less than ideal housing market. Since the collapse, the number of closings were on a downward trend, much like Nevada (down by 87.0 percent), but that is where the similarity ends. Unlike Nevada, in California, settlement costs had been on a downward trend, decreasing by 83.0 percent, much like we would expect with a dwindling number of closings. The number of claims was relatively flat over the time period.

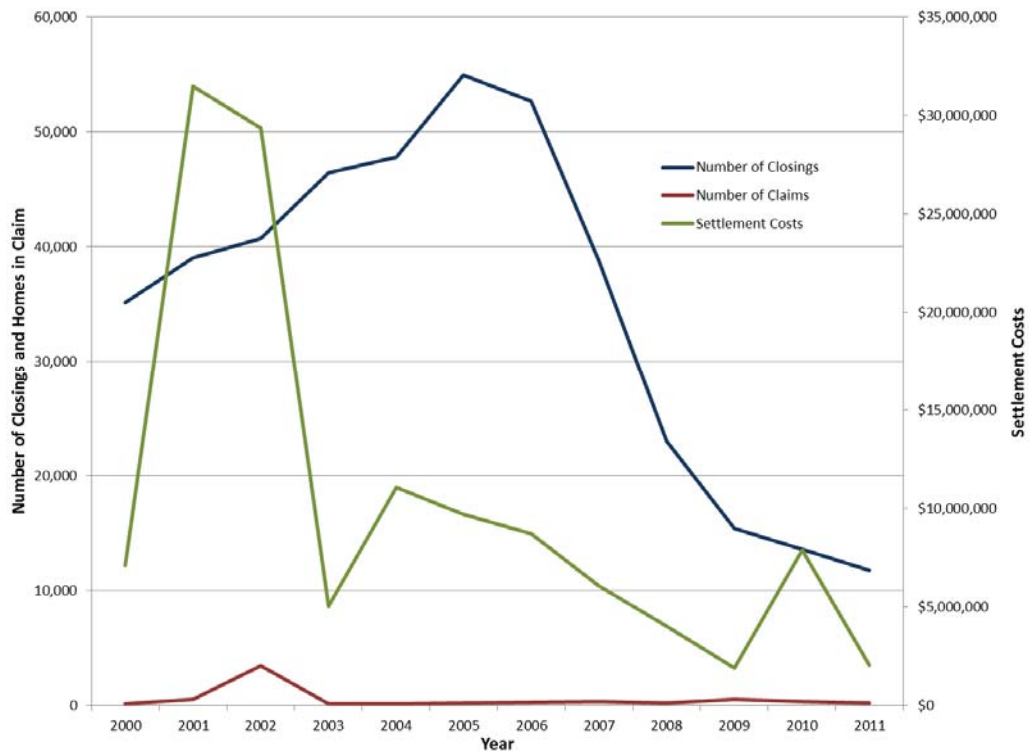
**Chart 9: Closings, Claims, and Settlement Costs in California**



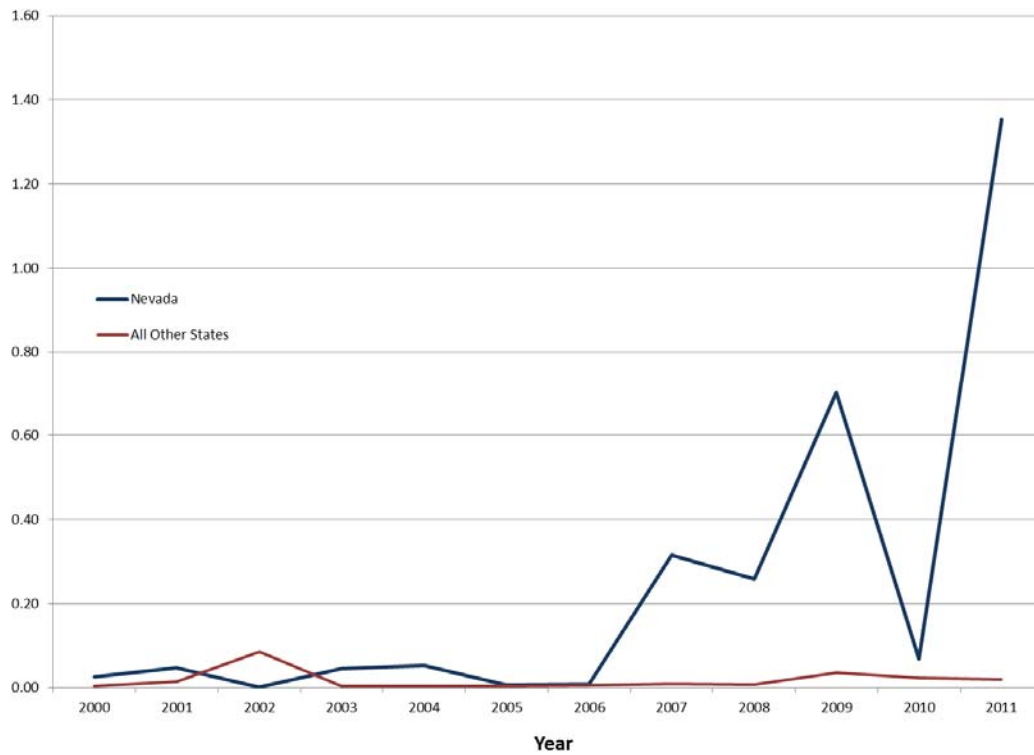
Lastly, Chart 10 shows the number of closings, the number of claims, and the settlement costs for the firms for all states other than Nevada and California. The trends in this chart are similar to those for California, with the number of closings and settlement costs decreasing by 79.0 percent each. The number of claims is somewhat constant.

In Chart 11, we present the number of claims per closing in Nevada versus all other states. We can see that the number of claims per closing in Nevada was significantly higher than in all other states since 2006. Nevada is the only state with a law written like Chapter 40. In 2011, the number of claims per closing reached 1.35 in Nevada. For the average of other states, the highest ratio was 0.035 claims per closing.

**Chart 10: Closings, Claims, and Settlement Costs in All Other States**



**Chart 11: Claims per Closing (ratio)**





### 4.2.3 Who Pays for Higher Building Defect Claims in Nevada?

As might be expected, increases in claims for building defects have led some insurance companies to exit the Nevada home builder liability market, and those remaining to charge much higher premiums. According to industry sources, Nevada premiums are about 85 percent of California’s. In more competitive western states, such as Arizona and Texas, the premiums are less than 50 percent of California’s. These builder-incurred premiums are passed on to the consumers in the form of higher prices for new homes.

Higher insurance premiums also may have reduced competition among builders because many of the large builders are able to self insure. From 2000 to 2012, the market share claimed by the top ten builders in Nevada rose from 36.0 to 78.0 percent (Table 5). In contrast, Builder Magazine’s annual “Builder 100” publication, found the top ten builders in the United States accounted for about 25 percent of the market in 2010 and 2011. Similar effects have been reported for subcontractors. A lack of competition in the Nevada housing market likely means higher costs to the consumers.

**Table 5: Top 10 Builders’ Market Share – Nevada**

Year	Total Permits	Top 10 Builders’ Permits	Market Share
1998	20,595	9,216	45%
1999	19,849	9,194	46%
2000	20,410	7,287	36%
2001	21,216	10,521	50%
2002	22,050	12,154	55%
2003	25,213	15,508	62%
2004	32,879	18,816	57%
2005	31,010	19,073	62%
2006	23,219	14,474	62%
2007	14,510	8,040	55%
2008	6,129	4,024	66%
2009	3,850	3,066	80%
2010	4,550	3,363	74%
2011	3,732	2,929	78%
2012	5,027	3,939	78%

Source: Home Builders Research

### 4.3.3 Revising Chapter 40 and the Nevada Housing Market Recovery

Because Chapter 40 has the demonstrated effect of increasing the prices that consumers pay for new homes, it likely has slowed the recovery in Nevada home construction, and by extension, the state’s economic growth. Without revisions to the law, Nevada home builders could see continually rising claims and costs. These escalating claims and settlement costs are likely to lead to higher insurance premiums for builders, fewer builders and higher prices for homes.

Ultimately, a reworked Chapter 40 could help foster stronger economic growth in Nevada by reducing the costs of building new homes. Builder liability insurance premiums would be reduced as the prospects for claims are reduced. Insurers would reenter the market. With insurance more widely available and at a lower cost, small builders would be encouraged to enter the market. The increased competition would drive down the cost of new home construction.

## **5. Conclusions**

Much of the strain on the Nevada economy during the Great Recession came from the burst of the housing bubble because real estate and construction are both vital to the health of Nevada's economy. While growing tourism and hospitality has led to some improvement, Nevada is behind a majority of the country in achieving a full economic recovery, mostly the result of weak real estate and construction sectors.

The most recent data suggest that we are in the early stages of a housing market recovery in Nevada. The real estate market, however, has a substantial overhang of residential and commercial property. In the residential market, little of that supply is on the market. The result has been moderate gains in residential real estate prices. With the overhang only likely to be dribbled on the market at a slow rate, residential housing prices can be expected to continue rising.

After about six years of sliding, Southern Nevada housing prices are on the rise. Most consider that a good sign. A lack of supply is contributing to the rise, and prices look set to increase over the next few years as the Southern Nevada economy improves. Nonetheless, the overhang of property held in weak hands could dampen any acceleration. In addition, the increase in claims and settlement costs made possible under Chapter 40 is likely to postpone the gains in construction by adding to the costs of new home construction

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