LAURA AND JOHN ARNOLD FOUNDATION

Swamped: How Pension Debt Is Sinking the Bayou City

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About the Authors

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The Laura and John Arnold Foundation's core objective is to address our nation's most pressing and persistent challenges using evidence-based, multi-disciplinary approaches. We strive to create functional solutions that target the root causes, not just the symptoms, of these problems. The solutions must be both scalable nationally and sustainable without permanent philanthropy.

I. Introduction

Every Houston city employee who works hard and plays by the rules deserves a fair and secure retirement. Yet the city leadership has mismanaged Houston's pension systems for decades, leaving them underfunded and on shaky ground. Political leaders have skimped on pension payments, used risky investment return assumptions, and ignored the warning signs of a serious problem. As a result, the pension debt has reached record levels in recent years, and the city currently owes workers at least $3.1 billion for retirement benefits they have already earned. To put that in perspective, Houston's pension debt is a *billion dollars more than the city's total general fund revenue.* If city leaders don't make real reforms, the pension debt, which is continuing to rise, will threaten Houston's ability to give workers and retirees the retirement they were promised. In addition, taxpayers may be forced to pay the price through higher taxes or reduced funding for roads, infrastructure, parks, and other public services that help make Houston a great place to live and work.

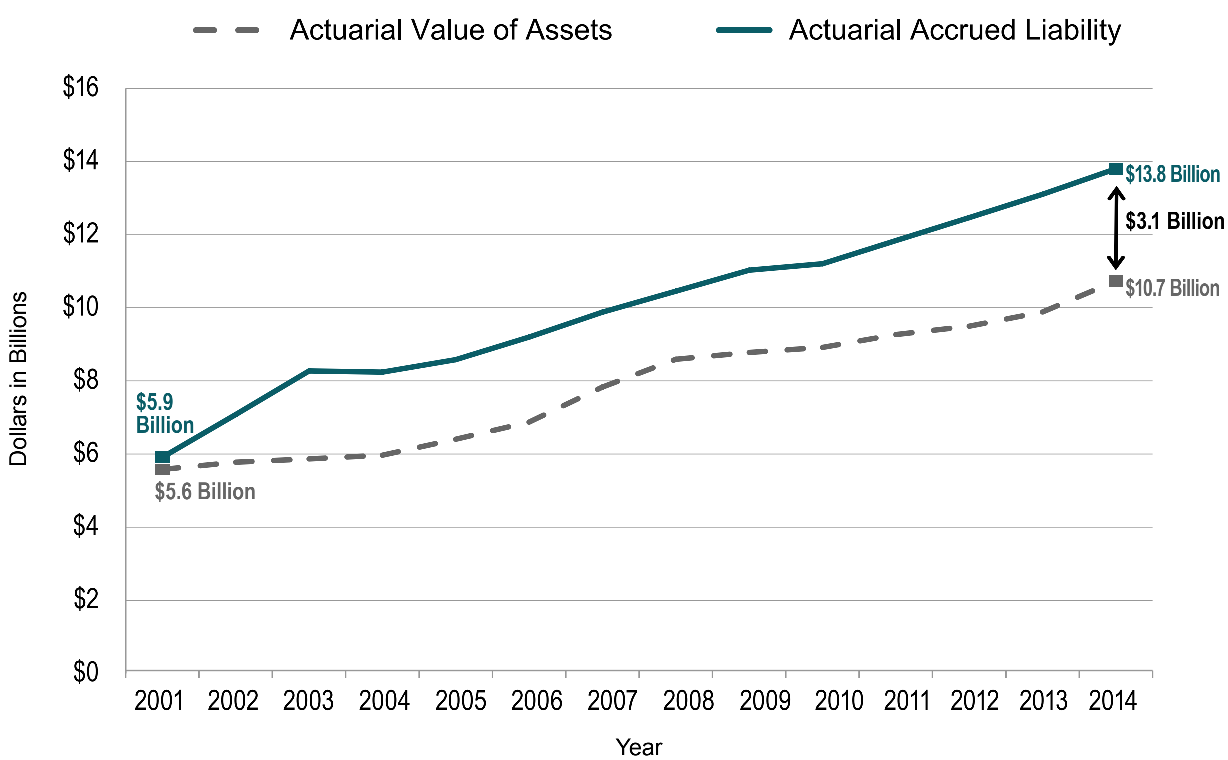
The political leaders in Houston can no longer afford to kick the can down the road. If they continue their irresponsible funding practices, there will be serious ramifications. That's what happened in Chicago, a city that was in roughly the same position 10 years ago that Houston is in today. When the alarm bells went off in Chicago a decade ago, political leaders there didn't change course. They continued to shortchange workers by failing to make responsible pension payments. That, combined with the 2008 national financial downturn, caused Chicago's pension debt to balloon into a full-blown financial crisis. The problems in Chicago have only gotten worse, even as the city's overall economy has improved. In Houston, the city's strong economic position has helped to cushion the impact of poor pension funding decisions thus far, but conditions are changing. The drop in the oil markets along with the property tax revenue cap could quickly magnify the city's pension problems and result in a crisis much like the one in Chicago.

In order to avoid dire consequences, local leaders must immediately take steps to fundamentally reform Houston's pension systems so that they are fair and sustainable for both workers and taxpayers. City officials must obtain local control over the city's pension systems in order to negotiate changes directly with workers and enact those changes locally. In addition, they must fully fund the pension systems; pay off the debt in 20 years or less; and make historical data, projections, and financial information publicly available.

II. The State of Houston's Pension Systems

In recent years, despite strong economic growth and significant increases in tax revenue, Houston's pension debt has reached record levels. The city owes workers in the Houston Firefighters' Relief and Retirement Fund, the Houston Police Officer's Pension System, and the Houston Municipal Employees Pension System at least $3.1 billion, and, according to the plans' own projections, Houston's pension systems are only 75 percent funded. In short, Houston does not have sufficient funding to deliver on its promises to city workers *(Figure 1)*.

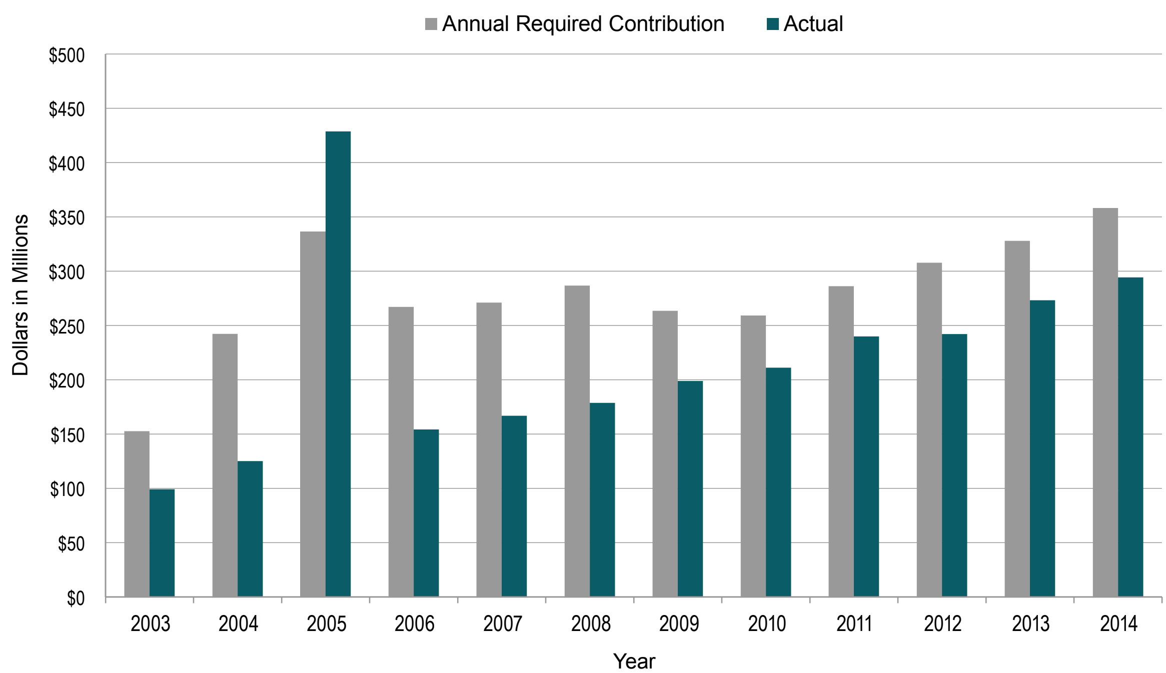
Figure 1 Houston Does Not Have Sufficient Funding to Deliver on Its Promises



Source: Comprehensive Annual Financial Reports and Actuarial Valuations for Houston Firefighters' Relief and Retirement Fund, Houston Police Officer's Pension System, and Houston Municipal Employees Pension System.

The funding gap is due in large part to the fact that the city hasn't been paying enough into the pension fund on an annual basis. Cities are expected to make what is known as an Annual Required Contribution. This is the amount needed to maintain the fiscal health of their pension systems. Given Houston's escalating debt, that figure has more than doubled since 2003 and is now equal to nearly one-fifth of the total general fund revenue. Yet, Houston has only paid a portion of the amount each year since 2006, despite the fact that it has increased the amount of money dedicated to pensions from about $150 million to nearly $300 million *(Figure 2)*. Even though local leaders have been putting significantly more money in each year, it's still not enough to cover what is required to adequately fund the pension systems. You don't have to be an economist to understand what happens when you don't make payments in full. Think of your mortgage or credit card bill. If you pay less now, it only means that you will end up paying more—and in Houston's case, much more—in the long run.

Figure 2 Houston Has Been Failing to Make Its Annual Required Contribution



Source: Comprehensive Annual Financial Reports and Actuarial Valuations for Houston Firefighters' Relief and Retirement Fund, Houston Police Officer's Pension System, and Houston Municipal Employees Pension System.

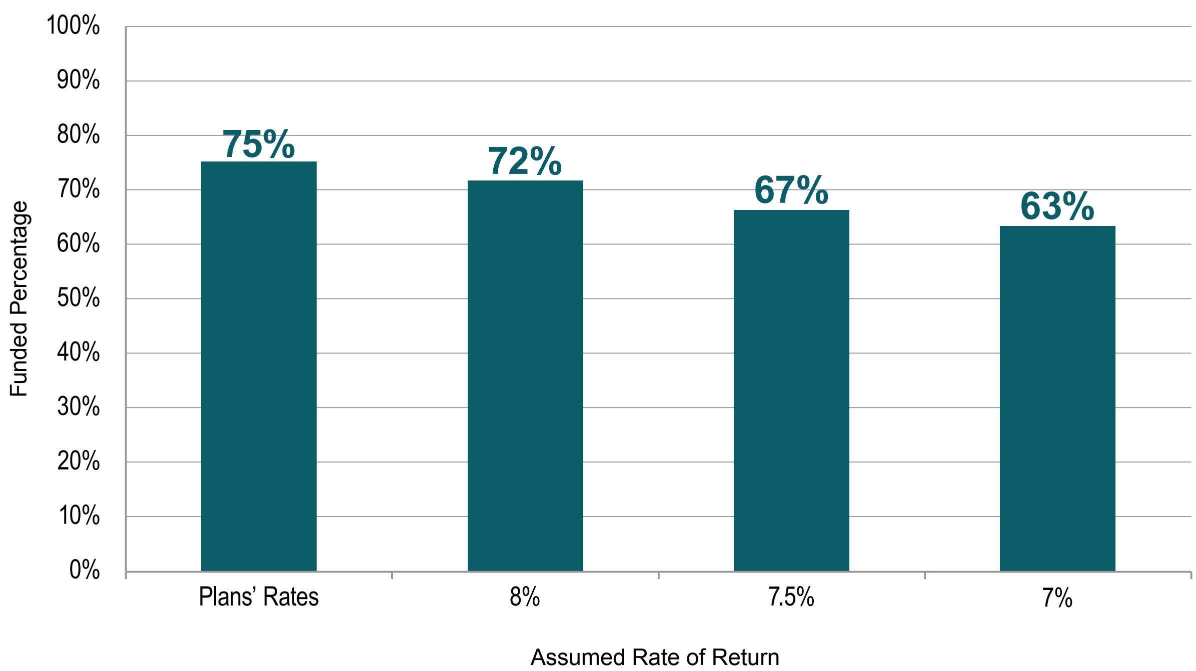
Note: City contributions in 2005 included a $300 million collateralized pension obligation note to the Houston Municipal Employees Pension System.

III. Risky Assumptions

There is a second major factor that has contributed to Houston's pension debt—an irresponsible funding policy that includes missed contributions and benefit increases awarded without a credible plan to pay for them. Political leaders have failed to address these issues and, instead, are betting on unlikely investment returns to pay off the debt.

The pension systems for Houston's firefighters and municipal employees use the *highest investment return assumption for any major plan in the United States—8.5 percent.* [1] Meanwhile, the pension system for Houston's police officers uses an investment return assumption of 8 percent, a number that is still higher than the national average. [2] With local leaders banking on these pie-in-the-sky returns, we can't get a true picture of the city's pension problems. It is likely that the debt is actually much larger than the city claims, as minor fluctuations in realized returns translate into sizable differences in funding levels. Consider these scenarios: Under an assumed rate of return of 7.5 percent, the plans' funded ratio, when considering the market value of assets, would fall from 75 percent to 67 percent *(Figure 3)*, and the debt would jump to approximately $5 billion.

Figure 3 Houston's Funding Level Is Likely Lower Than It Appears



Source: Comprehensive Annual Financial Reports and Actuarial Valuations for Houston Firefighters' Relief and Retirement Fund, Houston Police Officer's Pension System, and Houston Municipal Employees Pension System.

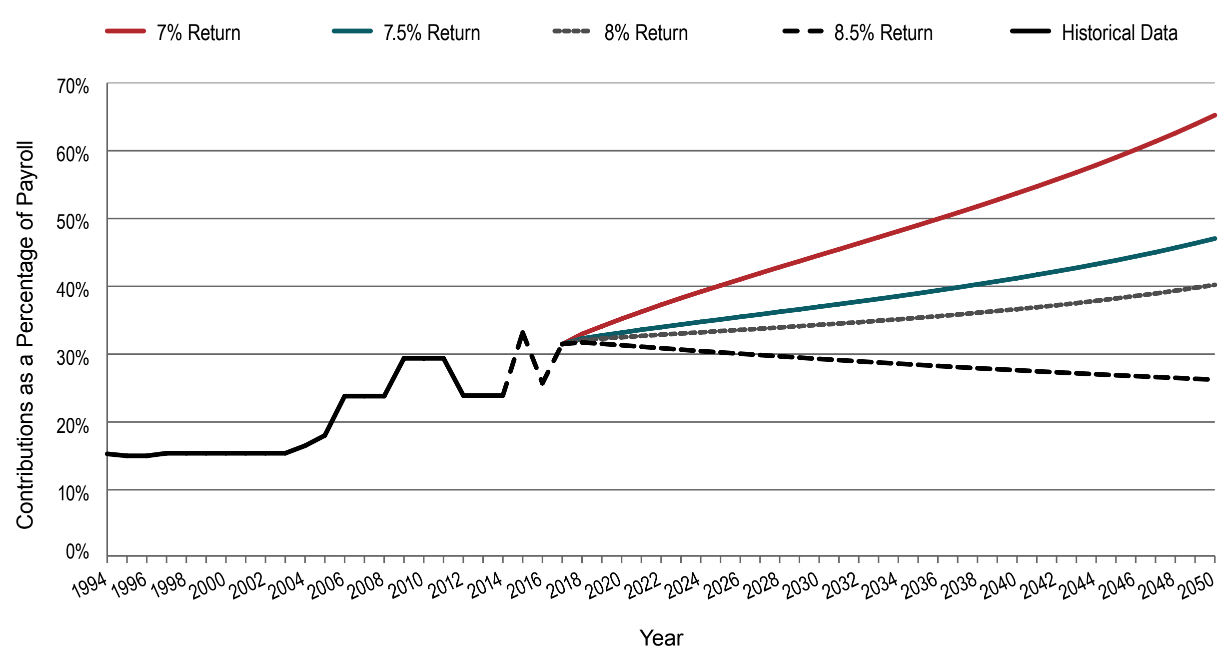
Note: Funded ratio is based on market value of assets.

1 Investment rate of return assumptions range from 5.5 to 8.5 percent. Public Plans Database. (2001-2013). Center for Retirement Research at Boston College, Center for State and Local Government Excellence, and National Association of State Retirement Administrators.

2 The mean investment rate of return assumption is 7.7 percent; the median is 7.75 percent. Public Plans Database. (2001-2013). Center for Retirement Research at Boston College, Center for State and Local Government Excellence, and National Association of State Retirement Administrators.

When assumptions are lowered to 7 percent—which is considered to be a reasonable expectation for future returns—the funding level falls to just 63 percent, and the debt skyrockets to $6.2 billion, nearly double the estimate currently provided by the plans. [3] Such an event could have a devastating effect on workers and taxpayers. For example, in the fire department alone, pension contributions could steadily increase to 50 percent of payroll *(Figure 4)*. In other words, one out of every three dollars could be spent on pension payments rather than used to give firefighters a raise or to hire additional responders to protect the city.

Figure 4 **Contribution Projections for Houston Firefighters' Relief and Retirement Fund**



Source: Actuarial Valuations for Houston Firefighters' Relief and Retirement Fund; authors' calculations.

In addition, given that the city relies on investment returns that it's unlikely to achieve over the long run, it isn't accurately calculating the annual contributions that are required to sustain the pension systems. In other words, since the numbers are skewed from the outset, the city's estimate does not truly reflect the amount of money needed to pay off the debt and establish financial security. Therefore, even if the city were to make its Annual Required Contribution, the pension systems would likely remain underfunded.

It's also worth noting that Houston has maintained the same assumptions even as returns have decreased for "risk-free" assets such as U.S. Treasury securities. This makes Houston's targets all the more improbable under the current market conditions. The city is taking on more risk than ever before and is setting itself up for a disaster in the event of an economic slowdown.

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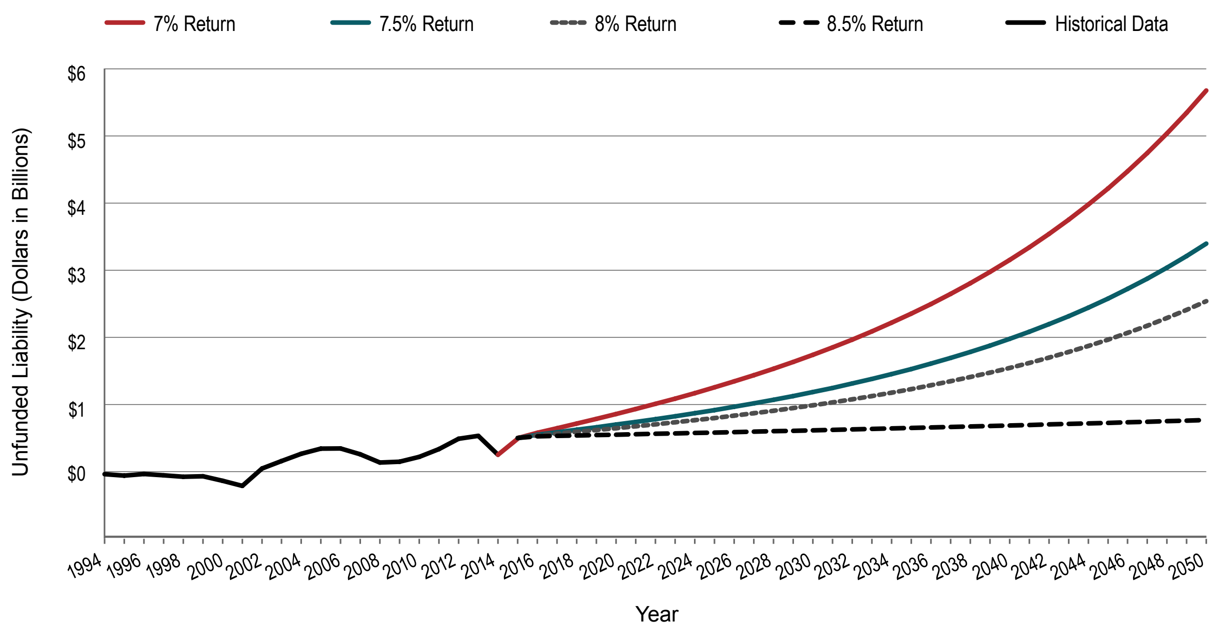
3 To calculate the value of liabilities using alternative discount rates, we apply the method used by Rauh, J. and Novy-Marx, R. (2009), The Liabilities and Risks of State-Sponsored Pension Plans. *Journal of Economic Perspectives,* 23(4).

If the economy falters, Houston will not only miss its projected rate of return, but will do so by a large margin. This would cause the debt to grow exponentially and would create a serious budgetary crisis *(Figure 5).*

Figure 5 Pension Debt for Houston Firefighters' Fund Will Increase



Source: Actuarial Valuations for Houston Firefighters' Relief and Retirement Fund; authors' calculations.

Recently, the California Public Employees' Retirement System (CalPERS), which is the largest public pension plan in the United States and holds assets more than 30 times greater than Houston's pension plans, reported investment returns of 2.4 percent for the last fiscal year—well below CalPERS' 7.5 percent assumed rate of return. It is likely that Houston will also experience years when returns are significantly below investment assumptions, and the city must account for this probability. [4]

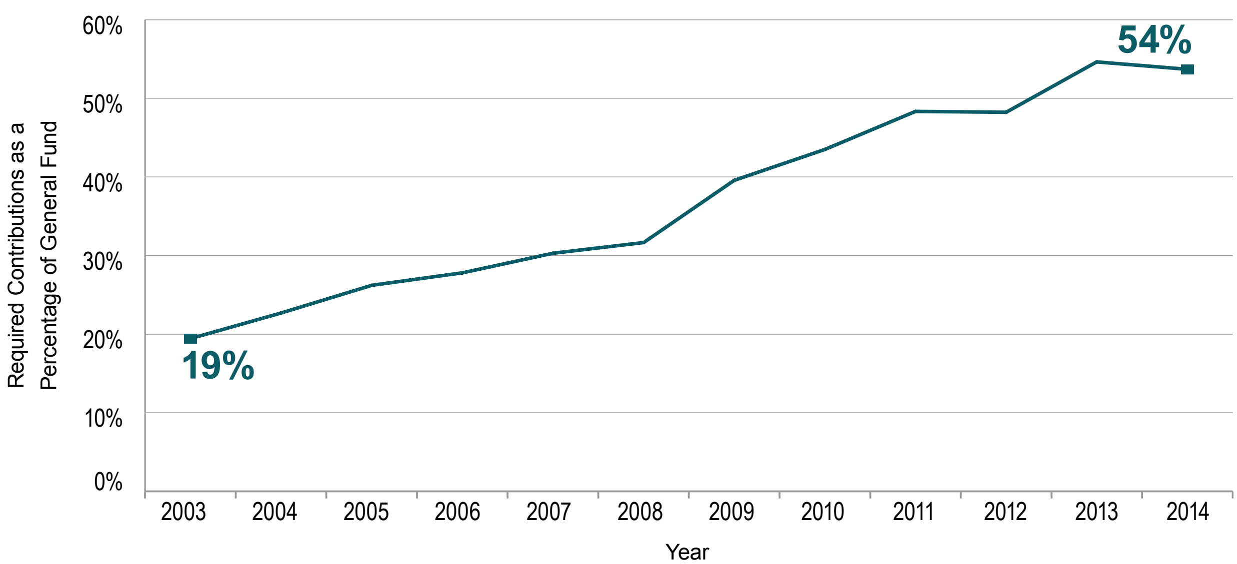
If Houston does not adopt responsible funding practices, the city will likely be forced to make difficult choices, which may include cutting workers' benefits; decreasing the amount of money for essential public safety measures such as hiring more firefighters or police officers and buying them protective equipment to keep them safe on the job; reducing investments in roads, infrastructure, and parks; and increasing sales or property taxes.

4 In light of CalPERS' performance, pension board members announced that they are considering lowering the fund's expected rate of return by up to a full percentage point to 6.5 percent over the next 20 to 30 years.

IV. Chicago and the Impact of Missed Contributions

Chicago provides an important case study as to how debt can rapidly increase if a city fails to make responsible pension payments. In 2003, Chicago's financial position was similar to Houston's current position. Chicago's Annual Required Contribution was equal to one-fifth of the city's general fund revenue. However, Chicago experienced a drop in revenue growth during the Great Recession in 2008 and 2009. This exacerbated the city's existing debt and failure to make sufficient payments to the pension systems. As a result, debt spiraled and contributions grew to 54 percent of the city's general fund revenue within a decade, even as the economy recovered. Despite the fact that Chicago has allocated larger amounts to its pension plans each year *(Figure 6),* the city is now experiencing a financial crisis. Chicago Public Schools has laid off more than a thousand employees, has eliminated 350 vacant positions, and is facing a projected budget shortfall of more than $500 million. [5] Both the city and school district debt have been downgraded to junk status.

Figure 6 **Chicago's Required Contributions Increased From 19 Percent to 54 Percent of the General Fund in Only 10 Years**



Source: Comprehensive Annual Financial Reports for the City of Chicago and Actuarial Valuations for Municipal Employees' Annuity and Benefit Fund of Chicago, Laborers' & Retirement Board Employees' Annuity & Benefit Fund of Chicago, Policemen's Annuity and Benefit Fund of Chicago, and Firemen's Annuity and Benefit Fund of Chicago.

5 Juan Perez Jr., Bill Ruthart, and Heather Gillers. (2015, July 1). CPS set for $200 million in cuts; mayor floats property tax plan. *Chicago Tribune.* Retrieved from http://www.chicagotribune.com/news/local/politics/ct-chicago-schools-pension-payment-met-0702-20150701-story.html.

While Houston's strong economic growth during this same period mitigated the effects of its rising pension debt, we are now seeing signs of a slowdown. According to an estimate released by the city, Houston is projected to reach the property tax revenue cap—which limits property tax revenue to the combined rates of inflation and population increases—in Fiscal Year 2016, which began July 1. [6] Therefore, Houston's ability to raise additional property tax revenue to cover the rising cost of the pension debt may be limited in the future. [7]

In addition, the energy market—which drives job growth and plays a critical role in Houston's economy—is experiencing a downturn. In his most recent report, Robert Gilmer of the Institute for Regional Forecasting wrote that he does not expect things to improve. He said, "The economic outlook for Houston has turned increasingly negative as we have moved into 2015. We have now reached the point where hopes for a short or moderate drilling downturn are behind us, as oil markets have turned down faster and plunged deeper than expected." [8]

The market downdraft could compound the impact of the revenue cap on Houston's revenue growth, thereby negatively affecting the city's ability to compensate for increases in pension obligations. If the city is unable to make contributions at a level that is equal to or greater than the current level, pension debt will grow at an unprecedented rate.

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6 Kelly Dowe. (2015). Presentation to the City of Houston Budget and Fiscal Affairs Committee: FY2016 Budget Overview and General Fund Five Year Forecast. Houston, TX: Author. Retrieved from http://www.houstontx.gov/council/1/bfacommittee/20150601/fiveyearforecast.pdf.

7 In addition, if the city removed the revenue cap, it is likely that a significant portion of any additional revenue would go toward the $52 million increase in required pension contributions for Fiscal Year 2016, rather than investments in other public services.

8 Robert Gilmer. (2015, June 23). Houston Outlook Grows Darker as the Oil Downturn Becomes Deeper and Longer. Retrieved from: http://www.bauer.uh.edu/centers/irf/houston-updates.php.

V. Conclusion

In order to ensure that workers receive the benefits they have earned and to protect funding for critical public services, Houston must obtain local control of its pension systems. Currently, state legislators from all over Texas, who may be unfamiliar with the funds' financial status, are making decisions about the city's pension systems. Local leaders need the authority to negotiate directly with workers and to enact any changes at the local level. While local control can only be granted by the Texas Legislature, there are other steps that Houston city leaders can and must take immediately to stop the pension systems' downward spiral and improve the plans' fiscal health. These include:

- Establishing payment schedules, as recommended by the Society of Actuaries Blue Ribbon Panel, that will allow the city to (i) pay off the pension debt in 20 years or less, and (ii) to remain debt-free in subsequent years. [9]
- Setting forward-looking investment return assumptions according to market conditions as recommended by the Society of Actuaries Blue Ribbon Panel.
- Publicly reporting the plans' performance over the last 10 years along with 30-year projections for at least two downside investment scenarios. Houston should use the projections to calculate and report the share of the city's revenue that would need to be devoted to pension payments under various market conditions.

By implementing these changes, Houston can design pension systems that are affordable, lasting, and fair.

Houston has ignored its pension problems for too long. It has failed to make responsible payments and has been making risky bets that will only end up costing more in the future. The city's pension debt continues to grow and is putting workers and taxpayers at risk. If political leaders continue to avoid these issues, Houston could face a crisis akin to the financial turmoil in Chicago. Local officials would then be forced to make difficult decisions, which could include cutting benefits; reducing funds for roads, infrastructure, and parks; or raising taxes. City leaders must do everything they can to avoid such a crisis. It is time to make meaningful reforms and fix Houston's pension systems once and for all.

9 Society of Actuaries Blue Ribbon Panel. (2014, February). Report of the Blue Ribbon Panel on Public Pension Plan Funding. Retrieved from https://www.soa.org/blueribbonpanel/.