A Story of Missed Opportunities:

How Houston's Pensions Got Hijacked

Houston's incoming administration is inheriting a city stripped of cash; a city that consistently spends more than it collects in revenues, with its operational resources steadily cannibalized by increasing pension contributions. Houston's fiscal worries are ripening at the worst time when its local economy is poised for an economic slow down in response to low oil prices. This is bound to translate into lower sales tax collections this year, most surely to be followed by lower property taxes within the next two years, if nothing changes.

Upcoming Credit Rating Downgrade

This is very likely to result in a credit rating downgrade at a time when Houston is in dire need of multibillion-dollar infrastructure investments, making borrowing in the capital markets costly. In July, Moody's Investors Service assigned a negative outlook to Houston's Aa2 bond rating, communicating the industry's concern regarding Houston's limited financial flexibility, perpetual structural deficits and ballooning long-term debt and unsustainable pension promises. A negative outlook implies that Moody's will evaluate Houston's fiscal condition and economic climate within the next three to six months to either downgrade the rating or remove the outlook. If Houston fails to take immediate action to reverse its negative fiscal course, a further downgrade is very likely.

We have already seen a very similar scenario unfold in Chicago whose credit rating Moody's dropped in May to junk despite the relative wealth and diversity of the city's tax base. The skyrocketing costs of servicing Chicago's unfunded pension liabilities and the burden they place on Chicago's ability to continue providing municipal services were the main drivers behind the downgrade. Two years ago on the pages of *The Houston Chronicle* I expressed an opinion that the road to Detroit may lie by way of Chicago[1]. Unfortunately, today we in Houston are much further down this road with no reversal of direction in sight.

Houston's recent history is a story of missed opportunities. A parade of city administrations has been unwilling to confront and contain the pursuit by key pension officials, aided by the state, to write in

[1] "Chicago and Detroit Offer Lessons in Long-term Debt". 2013. Elena Farah. *The Houston Chronicle* Available at http://www.chron.com/opinion/outlook/article/Farah-Chicago-and-Detroit-offer-lessons-in-4722972.php

statute ever more generous benefits without any concern of who will pay for them and how. It is a story of how not to run a pension system. Houston today is spiraling down into a service level insolvency with required pension payments consuming its operations, paralyzing Houston's ability to deliver adequate services. Worse, we may be very close to the tipping point after which Houston may collapse into a municipal bankruptcy, with even more time and millions lost in litigation, and outcomes uncertain for anyone involved.

Myth 1: Houston's economy is booming, and Houston should have plenty of money to honor its promises to employees – just look at the home prices

This is a fair assumption yet it is wrong, because for over a decade Houston has been spending more money than it is collecting in revenues. True, the most recent period of phenomenal growth flushed city coffers with cash. Houston's taxable property values increased 70 percent between 2007 and 2016, fully reversing the Great Recession declines. Since 2011, trends in Houston's major revenue sources, property (comprising 49 percent of revenues) and sales taxes (30 percent of revenues)[2] have remained the envy of other municipalities. Property taxes are up 30 percent over the last five years, and sales taxes grew by a robust 40 percent over the same period.[3] Yet Houston has managed to fully expend these extraordinary resources on operations, in addition to also drawing down reserves from the General Fund.

Audited fiscal 2014 unassigned General Fund balance equaled $200.7 million, or 9.6 percent of total revenues. Yet the Controller's office projects a series of draw downs on reserves since then nearly halving an estimated fiscal 2016 unassigned balance to approximately $120 million, at its lowest level in over the last decade (including the Great Recession years).[4] Such low levels of reserves are also below the statutory limit of seven and a half percent.[5] When Moody's evaluates the rating outlook for Houston, the trend of declining fund balances will certainly be a negative credit factor, consistent with a potential downgrade. Absence of a comfortable reserves cushion leaves Houston vulnerable to any emergency, like a hurricane or a flood.

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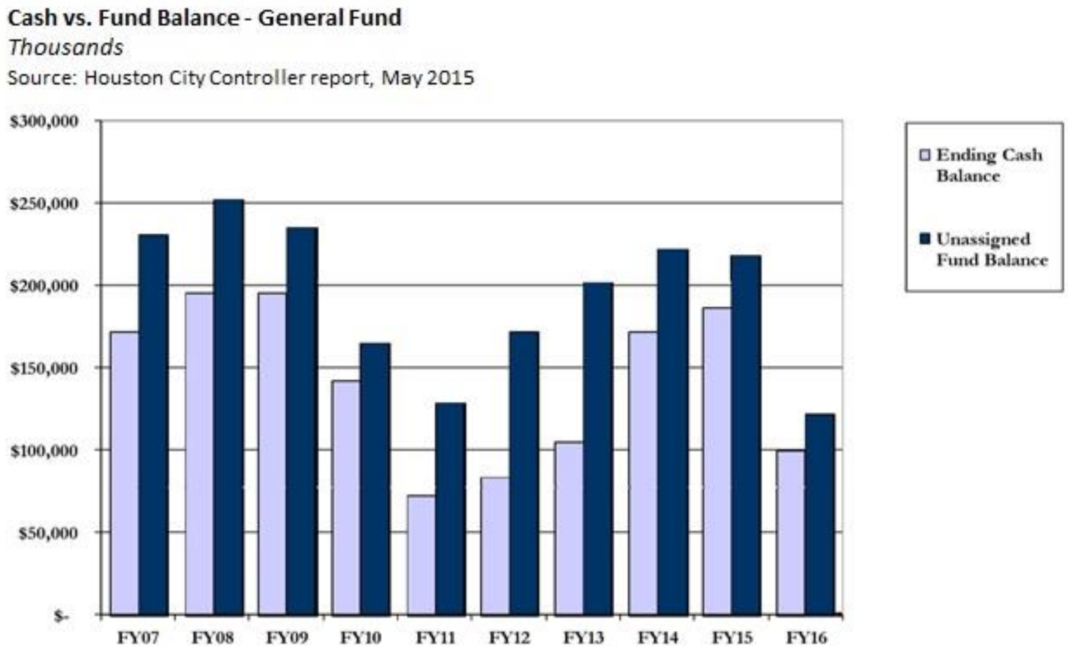
[2] 2014 Comprehensive Annual Financial Report for the City of Houston (CAFR)

[3] Audited fiscal 2011 numbers; Controller's projections for fiscal 2016 from *The Office of the City Controller* "Trends for fiscal year 2016" May 2015.

[4] Ibid.

[5] City budgetary policies require maintenance of an Unassigned Fund Balance in its General Fund of a minimum of 5 percent of total expenses less debt service. Any funds in excess of 7.5 percent of total expenses less debt service are available for non-recurring expenses (2014 CAFR). City ordinance 2014-1078, adopted December 2014, further requires an Undesignated Reserve of 7.5 percent of the General Fund Expenditures, less Debt Service Payments. This police change is not yet reflected in the most recent audited CAFR.

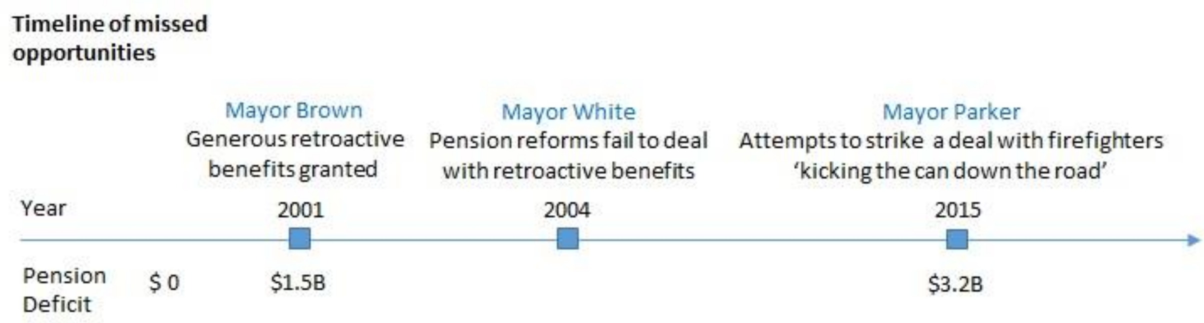


And Houston is in the middle of a pension hurricane. Its three pension systems are collectively in a fiscal ditch to the tune of at least $3.2 billion.[6] This means Houston would have to commit one and a half years of all of its General Fund revenues just to pay its pension bill – no trash pick up, no paying police and fire, no street repairs, no mommy-and-me library programs - for an entire year and a half. Yet even $3.2 billion is grossly understated because future obligations are priced using archaic discount rates of between 8 and 8.5 percent (highest in the nation), artificially deflating the amount actually owed. Estimated at more realistic market-based discount rates of 7.5 and 7 percent, pension debt increases very quickly to between $5 or $6.2 billion (twice the amount projected today),[7] and may be even higher if the market remains sluggish. Houston, we do indeed have a problem.

[6] 2014 CAFR

[7] "Swamped: How Pension Debt is Sinking the Bayou City." Josh McGee and Michelle Welch August 2015 Laura and John Arnold Foundation

Myth 2: The reason Houston has a $3.2 billion unfunded pension liability is simply because city officials have underfunded pensions for years and because of the Great Recession



Houston accumulated its pension debt in just over a decade primarily as a direct result of granting retroactive benefit increases in 2001. Subsequent decisions by a series of elected city administrators, often well intended, were off-target and failed to reverse the course. State lawmakers played their negative role by codifying unsustainable benefit increases in state laws and by resisting any efforts by Houston officials and taxpayer groups to arrive at a reasonable compromise. This is ultimately going to hurt the workers who will not be able to cash their pension checks short of any quick action to restore funds' solvency. The current generation of Houston employees many of whom already work more for less will be left holding an empty bag for the excesses of prior generations of workers.

The decision by Mayor Lee Brown's administration in 2001 to grant across-the-board generous retroactive benefit enhancements bankrupted the three pension systems.[8] Lack of transparency around the process of recommending, pricing and approving the new benefit structures resulted in insufficient scrutiny awarded to this decision at the time. Computing benefits is technically complex, highly sensitive to assumptions and generally of little interest, if not at all boring, to the broader public. City administrators agreed to the proposed changes (from which many of them themselves benefited), based on erroneous cost assumptions and under pressure from pension boards also overwhelmingly staffed with beneficiaries.[9]

The state subsequently approved and codified new benefits in its statutes. From then on, Houston would need support of pension boards and, ultimately, state approval to change the benefit formula, although the state has no responsibility for paying the bill. This split city-state control over pension

[8] For more details, see my articles on the *Inside Policy* blog "How Sustainable Are Houston's Pensions?" July 15, 2013 available at http://blog.chron.com/insidepolicy/2013/07/how-sustainable-are-houstons-pensions/ accessed September 15, 2015

[9] This is a classical example of a conflict of interest when interested parties are allowed to adopt policies from which they themselves benefit. The cost of this decision was immediately passed on to taxpayers.

policy limits city options, while giving the state ultimate decision-making authority without a corresponding financial responsibility. This in itself is a flawed legal design and must be changed.

The pricey mistake became obvious immediately. Enthusiastically touted by boards of trustees as "affordable", newly recalculated annual pension contributions skyrocketed to nearly half of payroll instead of the 15 percent of payroll promised by pension boards at the time of adoption[10]. For the municipal pensions alone Houston had to find an additional $100 million per year. Suddenly Houston woke up to a $1.5 billion pension gap. Prior to benefit increases Houston's pension debt was zero. Since 2001, Houston has never been able to pay its pension bill in full, paying pensions with a credit card and incurring interest costs of 8.5 percent per year.

The 2001 market slowdown further reduced the value of pension funds investments. Lower funded ratios spurred a statewide initiative to limit the ability of local jurisdictions to reduce pension benefits and write a pension protection clause into the state constitution. This initiative was successful, and in 2003 state voters passed a pension protection law making it illegal to reduce public pension benefits. The new constitutional protection applied to non-statewide systems only, effectively exempting the state from adhering to the same constraints it was now imposing on city and county-run pension systems. Proposition 15 contained a one-time opportunity for cities to opt out of this requirement.[11] Houston voters opted out of this law via a 2004 referendum championed by Mayor Bill White. Several other cities, including Galveston and Texas City, held similar elections to reserve the right to negotiate pension benefits at the local level going forward.

Under Mayor Bill White's leadership Houston city officials implemented a series of reforms creating new employee tiers with reduced benefits for the municipal and police systems and bonding part of these two systems' unfunded liability. The firefighters were unaffected because by state law they are not required to negotiate with the city and they normally choose not to. To this date they have refused to accept any concessions. Likewise, politically powerful seasoned municipal and police employees were exempt from any benefit cuts, while the burden of reduced benefits fell disproportionately on new

[10] "The Invisible Hand of Institutions: Who Governs State and Local Public Pensions?" 2013. Elena Farah.
[11] Article 16, § 66(d) of the Texas Constitution protects against impairment or reduction of accrued pension benefits "[A] change in service or disability retirement benefits or death benefits of a retirement system may not reduce or otherwise impair benefits accrued by a person if the person: (1) could have terminated employment or has terminated employment before the effective date of the change; and (2) would have been eligible for those benefits, without accumulating additional service under the retirement system, on any date on or after the effective date of the change had the change not occurred. Benefits granted to a retiree or other annuitant before the effective date of this section and in effect on that date may not be reduced or otherwise impaired." From "State Constitutional Protections for Public Sector Retirement Benefits" available at http://www.ncpers.org/files/News/03152007RetireBenefitProtections.pdf

employees who did not create the problem in the first place. This was truly a missed opportunity to divert upcoming crisis.

Mayor White's pension reforms were incomplete because they failed to deal with the original problem: retroactive benefit enhancements. In a final average salary defined benefit (FAS DB) pension plan, lifelong retirement payments must be prefunded over long careers through joint city and employee contributions and investment returns. Retroactive benefit increases, especially to seasoned employees approaching retirement, promise benefits yet disregard how they will be funded. Future taxpayers and frequently new workers have to shoulder the payments to keep systems solvent. Reducing benefits for future employees does nothing to reduce pension debt.

Soon a wave of retirement followed for all three systems. The number of workers retiring with inflated pensions doubled between 2007 and 2013 to 9,427 from 4,441 (municipal system) and to 2,906 from 1,491 (firefighter system). The police system saw a 43 percent increase in the number of pension beneficiaries over the same period. While police and fire systems grew their active force by 9 percent and 21 percent, respectively, the number of municipal employees actually shrank by 18 percent between 2007 and 2015.[12] This means that despite increased demand for Houston municipal services, the city now relies on a much smaller corps of workers to provide them. And there is no room in the budget to hire more people or pay workers higher salaries because legacy pensions are consuming an ever-larger share of revenues. It is also uncertain whether Houston will have any cash to pay current workers' benefits at all, given the dismal funding status of the municipal pension system.[13] Current municipal workers are getting a very bad deal and need to push for a meaningful pension reform of legacy pensions.

Reining in pension benefit formulas is also crucial to allow Houston to increase salaries and, most importantly, to hire much needed police, fire and other municipal workers. Houston's police chief recently expressed a need to hire 1,500 new police officers and investigators at a cost of $100 m dollars over five years to work through the backlog of criminal casework.[14] This will be impossible without first limiting ongoing pension accruals through renegotiated formulas.

Despite tough rhetoric, Mayor Anise Parker has failed to make pension funds solvent. Even worse, she attempted in one of her last actions as Mayor to perpetuate underfunding of the firefighter pensions in an effort to balance the current budget. Since I started covering pensions in Houston in 2012, pension debt spiked by three quarters of a billion. City administrators have been chronically shortchanging

[12] 2014 CAFR

[13] The funded ratio as of July 1, 2014 was 58.1 percent (assumed 8.5 discount rate)

[14] "Houston Matters" interview with Stephen Costello, September 15, 2015 available at http://www.houstonmatters.org/show/2015/09/15/steve-costello-mayoral-candidate-interview-tuesdays-show-september-15-2015

required annual municipal and police pension payments because the true cost of the bill is too high.[15] Yet every year of delayed funding costs taxpayers approximately 8.5 percent in interest, and the bill continues to grow. Pension clock is ticking, and inaction is pricey.

To be fair, Houston's pension systems took a serious hit from the Great Recession when its plans lost a quarter of their assets, just like most other plans in the nation. This shock was entirely absorbed by the city. This is because when pension funds lose assets due to unexpected market movements, the city is obligated to make them whole through extra payments.

Risk is fully divorced from reward in Houston's pension systems. The year the funds lost a quarter of their assets to the Great Recession, participants in its much-coveted deferred retirement (DROP) accounts[16] made and estimated 8 percent return on their investments. No wonder pension boards of trustees have zero incentive to negotiate for any changes in benefits, including DROP, despite the dire fiscal state of the funds. Pension funds are shielded from any fiscal pain by design solidified in state statutes, no matter how many financially detrimental decisions their boards of trustees make. When one hand is writing checks and another hand is paying bills, it is a recipe for a fiscal hurricane.

Houston pension boards of trustees have been very poor stewards of retirement security for their members, despite their rhetoric to the contrary. The three funds all have somewhat specific financial and legal situations and some have implemented partial reforms. Yet they are all alike in safeguarding the promise of a benefit yet being willing to undermine the safety of funding. Pension officials have pushed for benefits without any concern of whether Houston would be able to afford the payments. Lack of transparency around the process, absence of checks and balances in Houston's pension systems, perverse political incentives and state politicians meddling in what should be squarely local policy decisions have all contributed to the pension mess. The system is in dire need of reform to restore pension solvency and prevent anything like this from ever happening again.

[15] "How Sustainable Are Houston's Pensions?" July 15, 2013. available at http://blog.chron.com/insidepolicy/2013/07/how-sustainable-are-houstons-pensions/ accessed September 15, 2015
[16] "Poorly Structured Pensions Undermine Financial Sustainability," June 21, 2012 http://blog.chron.com/insidepolicy/2012/06/poorly-structured-pensions-undermine-financial-sustainability/

We are Seeing a Train Wreck Unfold in Slow Motion

Houston is very likely poised for a series of credit rating downgrades and may well end up in bankruptcy courts. Any pension reform that attempts to reduce benefits for current workers is also likely to end up in courts where elected judges accountable to well-organized political interests will have discretion to rule on the matter. Politicians fear touching the third rail of public pension reform because it is usually a suicidal political career move. This is especially true for those with aspirations for state offices. Public employee groups – especially public safety – tend to have much clout in state politics and may side rail campaign of political hopefuls they deem threatening to the status quo.

The reason we have not seen much progress on pensions in Houston is not because some city and state leaders have not sufficiently tried to sound alarm. Those who did have been unable to overcome the structural constraints of split control, political pressures and often a negative marketing campaign that accompanies talk of pension reform. Houston has no deficit of smart people who can offer reasonable reform solutions and alternatives are available. Freezing DROP accounts and containing COLAs[17] are the most urgent reforms to reduce the cost of legacy pensions yet preserve the bulk of the benefit. Yet Houston does appear to have a deficit of leadership to tackle the pension crisis in a non-partisan way, despite its proud history of non-partisan elections and state and local stated commitment to fiscal conservatism.

The assumption has always been that Houston needs to raise taxes to pay its pensions. Some combination of tax increase and benefit reductions is needed. At the same time, Houstonians are already paying more in taxes for less in services and it is going to get worse fast. Individual taxpayers are notoriously disorganized and uninformed[18], and often misinformed, on pensions. They are unlikely to present an organized movement to reform. It thus falls to the business community likely to shoulder the largest share of upcoming taxes to stay on top of the incoming administration to contain legacy pension costs. Absent a solution, we may well see a Detroit-like scenario unfold: as Houston introduces new "pension taxes" in an effort to feed the leaking systems, businesses may start a mass exodus from the city to the bustling suburbs. Recent relocation of Exxon Mobil to a Woodlands campus may be a canary in the mine. If the new Mayor continues sweeping the pension issue under the rug, we may see more businesses leave, which in turn will make it so much harder to repay debt. It is time to drop the "after me the flood" attitude and start finding serious pension solutions.

[17] Cost of living adjustments

[18] This is a typical collective action problem when a small but well-organized constituency dominates a policy discussion as the expense of a large and diverse, yet disorganized majority

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