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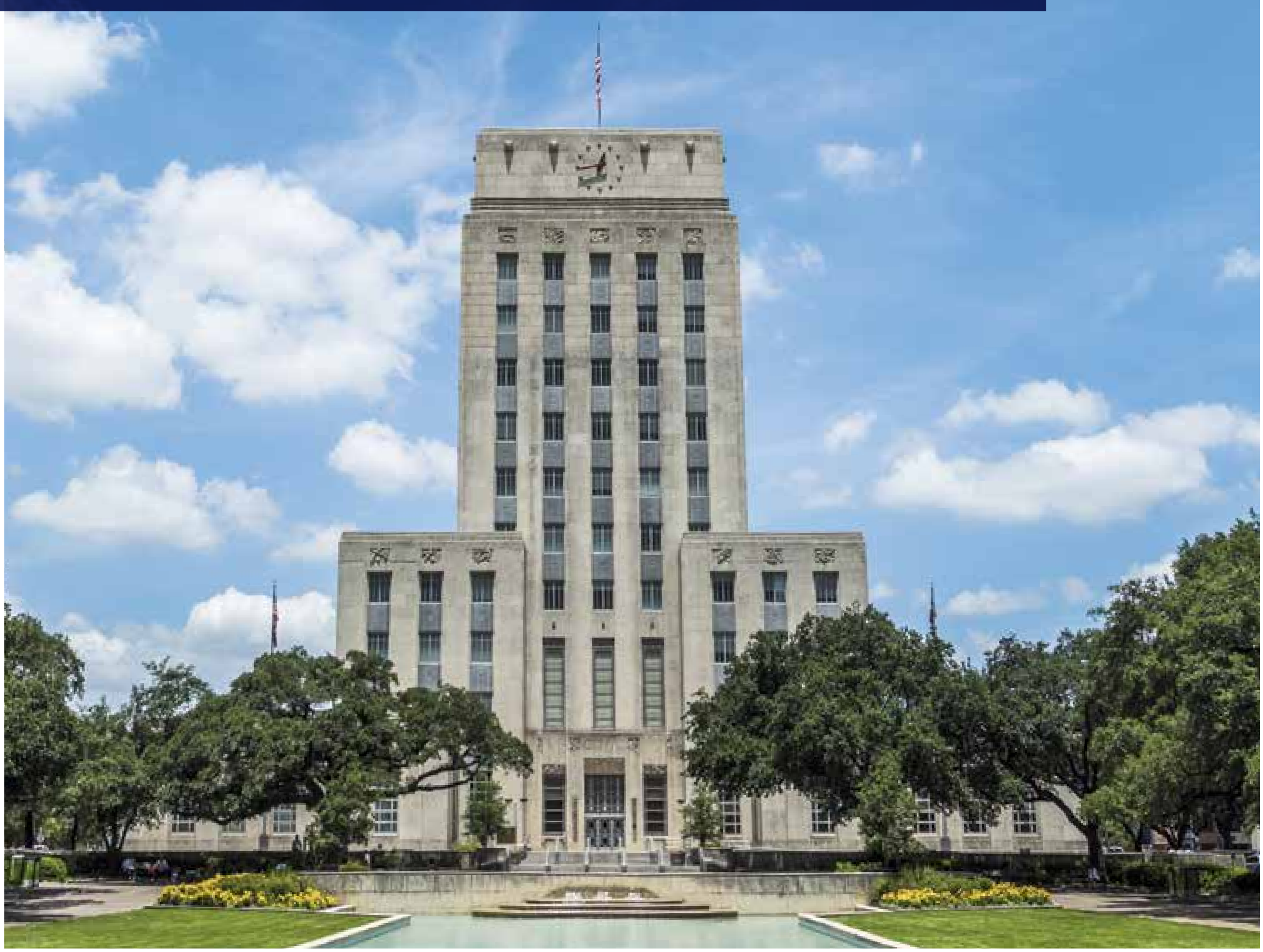
Building Better Cities

The Houston Pension Question:
How the City's Pension Liability Grew and the Options for Reform



Executive Summary

Houston today faces an increasing unfunded liability for its employee pensions that totals at least $3.9 billion, as of 2015, up from $212 million in 1992. If no action is taken, that unfunded liability (officially known as the unfunded actuarial accrual liability, or UAAL) is expected to continue growing. However, the city has some options—however painful—that can reduce the unfunded liability and restrain its future growth.

Background

As public discussion about Houston's pension issues grows, this report is designed to provide the public and policymakers with basic information about the city's pension systems and potential reform options. In this report, we seek to provide an overview of the current financial state of Houston's pensions; explain why the city's unfunded liabilities are growing; put Houston's pension situation in a national context; and provide insights on potential options for reform. We neither assign blame for the current situation nor make recommendations about specific steps to take.

Methodology

This study is based largely on an analysis the Kinder Institute commissioned from the Center for Retirement Research at Boston College, widely considered one of the country's most respected experts on public pensions. The Center's findings are based on an analysis of financial data about the pension plans from 1992 to 2014 because 1992 is the first year for which complete data is available on all three of Houston's plans. This report also draws on data from the Center's Public Plans Database, a database of information for 109 large state-run and 128 large locally-run pension systems around the country. In addition, this report draws upon a background paper prepared by John Diamond, the Edward A. and Hermena Hancock Kelly Fellow in Public Finance at the Baker Institute for Public Policy at Rice University. (Both underlying reports are available separately as appendices to this report.)

Summary

- Houston faces a pension challenge. Costs as a percentage of the city's revenue have doubled since the turn of the century and are likely to continue to increase if no action is taken.
- The city currently contributes approximately $350 million per year to the three pension funds combined, but this is not enough to stop the growth in unfunded liability.
- All three of Houston's pension systems are underfunded, with the Houston Municipal Employees Pension System (HMEPS) being the most severely underfunded.
- Underfunding has arisen from a variety of sources, including (1) annual payments that do not ensure full funding and (2) assumed rates of investment returns that are higher than the national average and higher than recent experience.
- Each of the three city plans will require a separate set of solutions because of the source of their costs. The greatest costs of the municipal workers plan are mainly to make up for the underfunding of previous promises (unfunded actuarial accrued liability, or UAAL), while the greatest cost of the police and firefighters plans are driven by year-to-year promises (normal cost).
- If Houston assumes a lower rate of return on investments going forward and chooses a fixed date by which its pension systems must be fully funded, as other cities have done, the city's required annual pension payment will increase significantly for the next 20–30 years.
- The reform experience of other cities suggests that, in order to pay down the unfunded liability and prevent that liability from growing, the city and the pension boards will have to find ways to substantially increase payments to the pension systems and also restrain future growth in the unfunded liability.
- The ideas contained in this document represent reforms that are likely to be painful but helpful. Raising the revenue cap would increase property taxes up to previous levels but has the potential to raise $40 million to $60 million per year or more if the economy picks up and property values rise. Increasing HMEPS employee contributions could generate $30 million per year at first, rising to $100 million per year over time, but would reduce workers' take-home pay. Reducing the COLA to 1 percent could save close to $100 million per year by some estimates at first but would put retirees at risk of falling behind inflation. Changes to the DROP program and the introduction of a defined contribution system would likely result in smaller savings but could be part of an overall solution.
- All of these options would generate different amounts of funding in different time frames. None would likely solve the problem alone.