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Pension Cost Burdens on Texas Cities and Counties

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Key Points

- Public pension costs represent a significant portion of city and county government spending.
- As public pension costs rise, the risk increases for taxpayers and beneficiaries alike.
- At the heart of the problem is the defined benefit system which promises a lifetime of monthly income, irrespective of the health of the fund.

Executive Summary

This study evaluates the burden of public employee pensions on Texas' local governments by computing the ratio of pension contributions to total revenue for over 300 cities and counties within the state. We find evidence that Texas municipalities generally compare favorably to those elsewhere around the country but could still benefit from reform. A major reason that Texas local governments stack up so well is that the state's two multi-employer plans limit the amount of risk transferred from employees to taxpayers. That said, the Texas County and District Retirement System (TCDRS) and the Texas Municipal Retirement System (TMRS) are not the same as defined contribution plans; an extended period of poor investment performance in these systems would have to be offset by additional taxpayer funding. Larger cities that have single-employer plans—especially Houston—tend to have greater pension burdens than local governments that participate in the multi-employer plans. Given the size and growth of this burden, it is important that state and local policymakers begin to examine ways to improve the affordability and reliability of these systems. One avenue to reform should include a restoration of local control of state-governed pension plans.

Pension Cost Burdens on Texas Cities and Counties

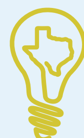
Public pension expenditures have become a major fiscal challenge for numerous U.S. cities. Soaring pension costs may also be posing current and future challenges for cities located in the Lone Star State, but identifying which ones is difficult because pension expenses are not typically reported by local governments as a discrete budgetary line item.

It is especially important to understand the landscape since in 2014 Texas cities and counties made a total of $2.2 billion in actuarially required pension contributions. These payments placed varying degrees of stress on local governments. In some cases, the costs were easily met, while in other instances, a city's or county's pension contributions crowded out other types of spending, and possibly even jeopardized the government's credit rating.

The purpose of this study is to measure pension burdens across 340 Texas cities and counties with more than 10,000 residents in order to determine where the greatest fiscal challenges exist.

Each government's pension burden was measured by dividing the entity's pension contribution by its total revenue. Performing this division allowed a look at a cross section of cities and counties on a comparable basis. The data could be standardized by using each jurisdiction's population, but revenue is a better measure because it takes into account differences in wealth across the state, as well as governments' varying ability to meet their financial obligations by taxing non-residents.

Most of the pension contribution data was obtained from two multi-employer plans, the Texas Municipal Retirement System and the Texas County and District Retirement System. While TCDRS serves virtually all Texas counties, many larger cities have their own plans in



The calculations for each Texas city and county are available at
pensions.thinklocalliberty.com

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lieu of or in addition to TMRS plans. For the 48 Texas cities that have single-employer plans, contribution information was obtained from the Pension Review Board (PRB), the state agency that oversees Texas' public retirement systems. As a general rule, Texas local governments make pension contributions roughly equivalent to the amount calculated by pension system actuaries. These actuarially required contributions are supposed to be sufficient to pay current retirees and to ensure that the pension system is fully funded to cover future retirees. However, the actuarial calculations typically rely on optimistic assumptions of future investment returns on pension assets, so it would be fair to argue that the ratios provided in this study somewhat understate local governments' true pension burdens.

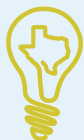
Revenue data was collected from audited financial reports filed by each city and county. These reports are typically available on a government's website or from the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system or EMMA. These reports include a set of statements adhering to norms established by the Government Accounting Standards Board. The measure of revenue used was the government-wide total derived from each entity's Statement of Activities. This is typically the highest revenue figure reported by a city or county, as it includes revenues collected by the general fund, special governmental funds, and "business-type activities," such as municipal utilities.

General Observations

Compared to other megastates, Texas' local governments appear to be better positioned to handle their pension obligations than many of their peers. In a prior study from the California Policy Center—see *California City Pension Burdens*—several California municipalities with pension costs exceeding 10 percent of revenue were identified. In Texas, no city exceeded the 10 percent threshold, and while three counties were over 10 percent, all three reached this level only because they made extra contributions over and above the actuarially required amount billed by TCDRS. The ability to make these additional contributions to raise the funded ratio of their plans is a positive signal.

Elsewhere in the country, individual local governments that fail to pay their full actuarially required contribution each year have much greater pension burdens. For example, Chicago's 2014 actuarially required contribution was 25 percent of total revenues, and in Cook County the proportion was 15 percent. Both of these governments only paid a small fraction of their actuarially required contributions in 2014, continuing an ongoing practice of severely underfunding their pensions.

Texas' multi-employer defined benefit plans avoid some of the pitfalls exhibited by plans in other states. Outside of Texas (and in the single-employer Texas plans discussed later), a common way to calculate a retiree's annual benefit is to multiply his annual compensation at the end of his career by a percentage based on the number of years of service. For example, a California public safety employee may receive 3 percent for each year worked. If he retires with 30 years of service, his pension will be 90 percent of career ending compensation. Many California public employers applied this rate to the final year's pay, but have now moved to using an average of the last three years' compensation. This change has reduced—but not eliminated—the practice of pension spiking, in which a soon-to-retire public employee works overtime or receives a last minute promotion



DID YOU KNOW?

Some retirement systems in Texas rely on overly optimistic investment assumptions to make actuarial determinations. For example, the Houston Firefighters' Relief and Retirement Fund (HFRRF) calculates its pension liability using a long-term expected rate of return on pension plan investments of 8.5 percent. During fiscal year 2015, the plan's investments returned just 1.53 percent. Over a 7- and 10-year period the rates of return were 6.4 percent and 7.9 percent, respectively. Not achieving these investment returns year after year can have a dramatic fiscal impact.

Even a small change in the actuarial assumptions can have major consequences for the fiscal health of a pension fund. According the HFRRF's 2015 Comprehensive Annual Financial Report, a 1 percent decrease in the current assumed rate of return (8.5 percent) would almost double the fund's pension liabilities, from $577.7 million to $989.5 million.

in order to maximize the career ending compensation level used to determine the annual pension.

Counties in TCDRS

The TCDRS (and, as we will see later, the TMRS) uses a method of calculating pension benefits that is much more resistant to pension spiking. As explained on the TCDRS website, an employee's pension benefit is based on contributions made throughout his or her career. These contributions are credited with 7 percent interest each year while the employee is working. At retirement, the aggregate value of the employee's contributions is matched by a fixed employer percentage to determine the size of the employee's pension. This amount is then converted into a monthly benefit.

While the TCDRS calculation method reduces risks to taxpayers arising from pension spiking, it is not the same as a 401(k) or IRA program in which all risks are shouldered by the retiree. TCDRS members benefit from the fixed 7 percent interest rate applied to their deposits. Private sector employees have no similar guaranteed growth option. They may achieve 7 percent or higher growth, but that will depend on their selection of investment options and the performance of these options.

Also, the calculation of the monthly benefit transfers risk from the employee to taxpayers. Employees who substantially outlast their life expectancy will receive much greater lifetime benefits at the expense of their public sector employer, and, ultimately, the taxpayers who finance these entities.

The TCDRS gives member counties and districts control over certain plan provisions. The choices made by these employers affect the pension burdens imposed upon taxpayers. The most important discretionary plan provisions are the employee deposit rate and the employer matching rate. The employee deposit rate is the percentage of each paycheck withheld and placed into the plan; it can range from 4 percent to 7 percent. The employer matching rate is the amount added to the employee's balance at the time of the retirement; it ranges from 100 percent to 250 percent.

Counties that choose higher deposit and matching rates have higher pension costs. While the correlation between matching rate and cost is obvious, the deposit rate also drives costs because the more employees deposit, the more that must be matched.

Counties with high matching rates and high deposit rates may be expected to be among those with the highest pension cost burdens. It is thus not surprising to see two counties with the maximum deposit rate (7 percent) and maximum matching rate (250 percent) near the top of our list, including: El Paso County (8.19 percent) and Ector County (7.45 percent), which is home to the city of Odessa.

Cities with the highest pension burdens have relatively generous plan provisions. The city with the highest pension contribution to revenue ratio is Allen (9.06 percent), a small municipality southeast of Dallas.

As mentioned above, three counties appeared at the top of our list in part because they made pension contributions in excess of those required by actuarial calculations. These are Dawson, Panola, and Hutchinson counties. As a result of making extra contributions, these three counties enjoyed higher funded ratios in their respective plans. While TCDRS had an overall funded ratio of 90.5 percent, Panola County's TCDRS plan was 105 percent funded. That said, Panola County has the same generous matching and deposit rates as El Paso and Ector Counties, so it may need to continue making excess contributions to remain in a fully funded state.

Among the state's largest counties, only Tarrant County had a pension cost to revenue ratio in excess of 6 percent, and this was attributable to an excess $4,000,000 contribution made by the county. The other large counties—Bexar, Dallas, Harris and Travis—had ratios ranging from 3.8 percent to 5.5 percent.

Cities in TMRS

The TCDRS and the TMRS employ similar approaches to determining employee pension benefits. Like the TCDRS, the TMRS uses employee contributions, interest, and an employer match to determine a total pension benefit, which can then be annuitized. There are, however, several differ-

HOUSTON, WE HAVE A PENSION PROBLEM

Pension Debt Soars in the Bayou City

Houston is home to three major local pension plans: the Houston Police Officers Pension System (HPOPS), the Houston Firefighters' Relief and Retirement Fund (HFRRF), and the Houston Municipal Employees Pension System (HMEPS). Each of these systems is established in state law as a defined benefit (DB) plan, a type of pension that guarantees participants a lifetime income based on salary and length of public service. This guarantee is made irrespective of the fiscal health or condition of the retirement system providing the benefits—a troubling feature that has created heartache and hardship for taxpayers and beneficiaries alike around the nation.

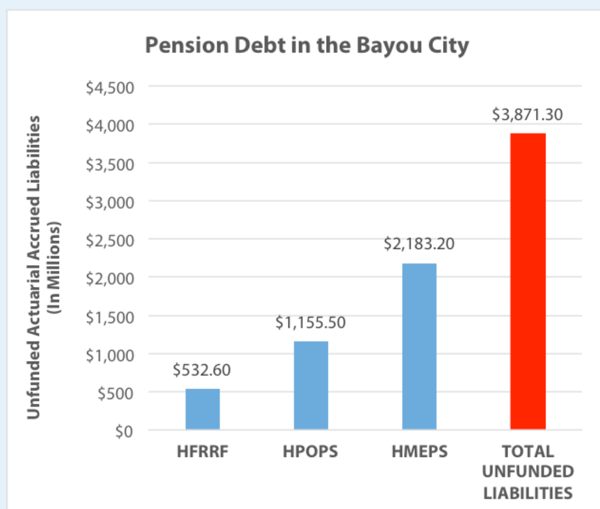
Much like other cities' financial struggles with defined benefit systems, Houston's DB pension plans are also faced with fiscal difficulties.

According to the Pension Review Board's (PRB) latest Actuarial Valuations Report, the plans' unfunded liabilities, which can also be thought of as future tax obligations, amounted to a combined $3.9 billion in May 2016. Individually, unfunded liabilities among the plans totaled: HFRRF, $532.6 million; HPOPS, $1.2 billion; and HMEPS, $2.2 billion.

In addition to soaring unfunded liabilities, the plans' funded ratios, a measure of a plan's current assets as a share of its liabilities, were also less than ideal. Generally speaking, pension professionals look for funded ratios to be at or above the 80 percent mark, with anything below that threshold possibly indicating an inability to meet long-term obligations. Only one plan, the HFRRF, managed to rate above the 80 percent mark, at 86.56 percent, while the funded ratios for HPOPS and HMEPS were at 79.75 percent and 54.19 percent, respectively.

Another measure, the plans' amortization period, is yet another indicator of looming pension problems. An amortization period measures "the length of time, in years, needed to pay for the UAAL, and reflects a system's ability to pay its normal cost plus its unfunded actuarial accrued liability" and, according to the PRB, is one of the best measures of a system's financial health. The PRB's guidelines for actuarial soundness recommend that a plan's amortization period not exceed 25 years; but a majority of Houston's plans do just that.

The amortization periods for two of Houston's three local retirement systems exceeded the PRB's recommended period, with the HFRRF at 30 years while HMEPS' was 32 years. Only the amortization period for HPOPS' was within the recommended guideline, at 23 years.



Even though the evidence clearly indicates that Houston's defined benefit pension plans are struggling under the status quo, posing a threat to both taxpayers and retirees, reforming the systems has proven quite difficult.

That's because the plans are established in state law and good government changes cannot be made without first getting legislative approval. This sort of sweetheart setup, enjoyed by many of Texas' big city plans, is something that conservatives attempted to undo last session, unsuccessfully.

Another effort to restore local pension control and allow for community-driven good government reforms is expected next session.

ences between the two systems. TMRS applies a 3 percent annual credit to employee contributions, in contrast to the 7 percent rate employed by TCDRS. The maximum employer match is also lower: 200 percent versus 250 percent. In one respect, TMRS is more generous than TCDRS: it provides employers the option of partially indexing retiree benefits to inflation. City employers can choose to give retirees annual increases of 30 percent, 50 percent, or 70 percent of inflation as measured by the Bureau of Labor Statistics' Consumer Price Index. TMRS' maximum employee deposit rate of 7 percent is the same as TCDRS' top rate.

Cities with the highest pension burdens have relatively generous plan provisions. The city with the highest pension contribution to revenue ratio is Allen (9.06 percent), a small municipality southeast of Dallas. Allen has a 7 percent employee deposit rate, a 200 percent employer matching rate, and a 70 percent "increased benefit rate" (i.e., the percentage of CPI by which retiree benefits increase)—these are the highest options for all three plan provisions.

The next two cities on the list have the maximum levels for two of the three major TMRS plan provisions. Deer Park (8.11 percent) has a deposit rate of 7 percent and a matching rate of 200 percent, but an increased benefit rate of only 50 percent. Alamo Heights (7.28 percent) has the maximum matching rate and increased benefit rate, but an employee deposit rate of only 6 percent.

Cities with Independent Plans

While 48 Texas cities have their own single-employer pension plans, many of them use TMRS for some classes of employees. A relatively common scenario is for a city's firefighters to be in a city plan, while all other employees participate in TMRS. Examples of cities using this combination are Abilene, McAllen, and Texarkana.

On the other hand, a number of the largest cities in Texas exclusively rely upon single-employer plans. These include Austin, Dallas, El Paso, and Houston (San Antonio has a single-employer plan for both firefighters and police officers, while using TMRS for other employees).

While Austin's pension burden places it near the middle of our list, the other three large cities relying on single-employer plans rank relatively high. The most burdened of these large cities, Houston (7.28 percent) has received substantial media attention, but Dallas (6.73 percent) and El Paso (6.62 percent) are not far behind.

Houston's retirement plan provisions create more taxpayer risk than the provisions in TCDRS and TMRS plans. Benefits are typically based on the highest months of compensation—creating the opportunity for pension spiking. This final salary is then multiplied by a percentage determined by the number of years the retiree has worked. For firefighters, this percentage is 50 percent plus 3 percent for each year worked after 20. For example, a Houston firefighter retiring after 30 years' service receives 80 percent of the average of final salary—which, in the case of the Houston Firefighters' Relief and Retirement Fund, is the average of the employee's compensation during his 36 months of highest pay. Finally, Houston offers annual inflation adjustments that are more generous than those in all TMRS cities.

Voters in Houston, Dallas, El Paso, and other cities should be given the power to adjust their local plans to improve their affordability and long-term reliability. The terms of a city's pension plan are best addressed at the local level, and not by the state's Legislature.

Single-employer plans in Dallas and El Paso have roughly similar structures to those in Houston. One provision unique to the two Houston public safety plans is that they have no minimum retirement age. El Paso has a 45-year minimum retirement age for police and firefighters hired before June 30, 2007; those hired subsequently must wait until age 50. Dallas has minimum retirement ages for public safety employees ranging from 50 to 55. (*Plan provisions for single-employer retirement systems discussed here were obtained from the Pension Review Board in response to a Public Information Act request.*)

Policy Recommendations

Given the relatively high pension burdens in single-employer plans, the attention of policymakers should focus more heavily on remedying the emerging fiscal situations

in those. Voters in Houston, Dallas, El Paso, and other cities should be given the power to adjust their local plans to improve their affordability and long-term reliability. The terms of a city's pension plan are best addressed at the local level, and not by the state's Legislature.

Local governments relying on TMRS and TCDRS plans are generally in better shape, but results vary. Cities and counties choosing high deposit and match rates within these systems may wish to consider whether these relatively generous terms are required to attract and retain quality staff.

Although TCDRS and TMRS provide greater taxpayer protection than the single-employer systems, all defined benefit plans shift risk from workers to taxpayers. Cities and counties can best protect their constituents from pension-driven tax spikes and service cuts by migrating to defined contribution systems.

Shifting to a defined contribution model, which the private sector has already embraced, would go far to improve the sustainability, reliability, and affordability of Texas' public retirement systems. To learn more about the benefits of transitioning from a defined benefit system to a defined contribution model, read the Texas Public Policy Foundation's 2011 report, "Reforming Texas' State and Local Pension Systems for the 21st Century."

Conclusion

Most Texas cities and counties have relatively modest pension cost burdens compared to systems in other big states, largely due to the unique structures of TCDRS and TMRS. That said, some local governments choosing generous options under the multi-employer plans are paying more than 7 percent of their revenue in public employee pension contributions. These levels will increase if recent, lackluster stock market performance continues and investment returns are less than expected. Cities and counties that have high dependence on the oil industry could face stagnant or declining revenues, which will further escalate their pension cost to revenue ratios.

Some counties have responded to funding challenges by making extra contributions—setting aside additional money in good times to address the potentially adverse future conditions.

Houston, and to a somewhat lesser extent, Dallas and El Paso are burdened by more traditional pension systems with generous features. Because the provisions for these plans are written into state statute, they will be difficult to reform. Transferring control of these plans to local voters would be a good first step toward more sustainable pensions statewide. ✫

Endnote

[1] A full description of TMRS provisions can be found in the system's Comprehensive Annual Financial Report.

About the Authors

James Quintero is the director of the Center for Local Governance at the Texas Public Policy Foundation, one of America's premier conservative think tanks. He's been featured in ***The New York Times, Forbes,*** The Huffington Post, Fox News and Breitbart. Since joining the Foundation in 2008, Quintero has focused his research efforts on state and local government spending, debt, taxes, financial transparency, annexation, and pension reform.

Prior to joining the Foundation, Quintero was a graduate research assistant at Texas State University, where he worked to educate high school students on financial aid and scholarship opportunities.

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