A Boomtown at Risk:
Austin's Mounting Public Pension Debt

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Our core objective is to improve the lives of individuals by strengthening our social, governmental, and economic systems.

Introduction

Austin is known as a modern-day American boomtown. In the last 25 years, its population has doubled as businesses and residents have moved to the area in droves, drawn by the strong local economy, diverse culture, and access to outdoor resources.[1] The city's thriving technology sector and growing hospitality and financial services sectors have propelled it to the top of numerous "best of" lists, from *Forbes'* "Cities of the Future" to WalletHub's ranking of the country's strongest job markets. The local government—which employs more than 13,000 people—is also recognized worldwide as an entity that is getting it right when it comes to addressing urban challenges.

Yet despite the numerous accolades, local leaders, including Mayor Steve Adler, have acknowledged that Austin's rapid growth is creating long-term challenges. The city weathered economic downturns such as the 2008 recession and the recent oil bust better than others in Texas, but it now faces one financial problem that communities from Houston to El Paso are also confronting—underfunded public pensions.

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Austin owes nearly $1.8 billion in pension debt, and its pension plans do not have enough money to pay for nearly one third of the retirement benefits that workers have already earned. What's more concerning, however, is that during the last decade, pension debt has grown faster than general fund revenue. At the same time, Austin's pension payments have increased dramatically—by at least $81 million.[2] While the recent period of unprecedented economic development has helped to mitigate the effects of the pension debt, it could be much more difficult for the city to raise the additional funds needed to cover rising pension payments in the future.

The rapid increase in the city's pension costs is due in part to the fact that the demand for public services has soared as more residents have moved to the region. While other strapped local governments around the country cut positions, Austin hired more than 1,000 workers between 2013 and 2016, according to budget documents. As the workforce grew, Austin failed to

1 United States Census Bureau and the City of Austin. (2016). "City of Austin Population History." Retrieved from https://www.austintexas.gov/sites/default/files/files/Planning/Demographics/population_history_pub.pdf.

2 There is limited publicly available information about the Fire Fighters Relief and Retirement Fund's Actuarially Determined Contributions and actual contributions during the time period studied.

make its contributions in full to the Employees' Retirement System, which is the city's largest plan. The underfunding, coupled with a series of investment shortfalls, has led to a widening gap between the plan's assets and liabilities. As a result, Austin now spends more than half of its pension payments on debt, rather than on new benefits for workers.

The increase in the size of Austin's workforce also means that the city is on the hook for larger retirement promises relative to the size of its revenue. Therefore, the pension debt now poses a greater risk to the city's financial stability. If Austin experiences an economic downturn in the future, it might not be able to keep up with its payments, and the rate at which pension debt accrues could accelerate, creating even greater budgetary pressure.

Local leaders only need to look 200 miles north to Dallas to see how quickly unfunded pension liabilities can spiral out of control. In 2014, the Dallas Police and Fire Pension System reported that it was in a similar financial position to the one that Austin's pension system is in now. At that time, the Dallas plan reported that it was 75 percent funded, and its unfunded liability was roughly $2 billion. In just two years, the debt doubled to $4 billion, and the plan's funded ratio plummeted to 45 percent. Facing significant funding challenges, Dallas has been left with few options other than to raise taxes, cut programs, or reduce wages and benefits for workers in order to pay down its pension debt.

Dallas provides an important warning to communities across Texas, including Austin. If local leaders ignore the pension debt, the problem will get worse. Although the issues Austin currently faces are not as severe as those in Dallas, city leaders in Austin should take action to improve the stability of the pension plans before the problem becomes too big to fix. Policymakers must make reforms now in order to ensure that the pension system remains financially sustainable and the city is able to uphold the retirement promises it has made to its dedicated public workers.

Statement of the Problem

For years, policymakers across the state, and even around the country, have kicked the can down the road when it comes to fixing their public pensions. Some have argued that as long as pension plans remain 80 percent funded or close to it, the systems are financially stable. Proponents of this view say that the plans have nearly enough to cover what is owed to workers, and moreover, the benefits will not actually be paid out until many years later.

This is simply not true. In a policy brief titled "The 80% Pension Funding Standard Myth," the American Academy of Actuaries wrote that "No single level of funding should be identified as a defining line between a 'healthy' and an 'unhealthy' pension plan."[3] The Academy went on to say that it is important to consider a number of other factors when evaluating a pension plan, including the size of the plan's promises relative to the government's ability to pay for them.

Table 1. Austin's Pension Debt Is More Than Two Times Larger Than General Fund Revenue

Plan	Pension Debt (in Millions)	Funded Ratio	Share of Total Shortfall	ADC* (in Millions)	Actual Contribution (in Millions)	Percent of ADC Contributed
Austin Pension Plans	**$1,760**	**67.0%**	**100.0%**	**$149**	**$153**	**102.7%**
City of Austin Employees' Retirement System	$1,247	63.2%	70.8%	$98	$100	102.0%
City of Austin Police Retirement System	$385	62.6%	21.9%	$33	$33	100.0%
Austin Fire Fighters Relief and Retirement Fund	$128	85.9%	7.3%	$17	$19	112.0%

Austin General Fund Revenue	$737 Million

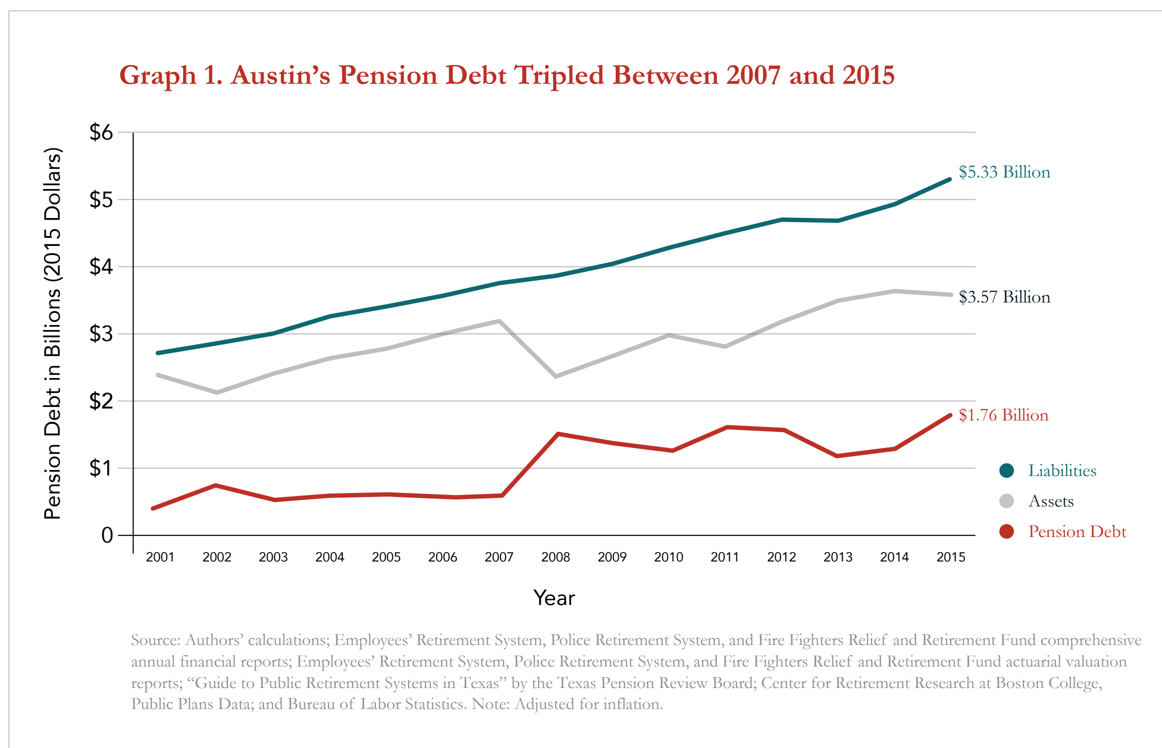
Source: Authors' calculations; City of Austin, Employees' Retirement System, Police Retirement System and Fire Fighters Relief and Retirement Fund comprehensive annual financial reports; Employees' Retirement System, Police Retirement System, and Fire Fighters Relief and Retirement Fund actuarial valuation reports; and "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board. *Actuarially Determined Contribution (ADC) Note: Although the city has paid its ADC—or the amount it should contribute annually to cover the cost of debt and benefits for current workers—in full to the pension plans in recent years, local leaders skipped payments to the Employees' Retirement System during the mid to late 2000s.

The policy brief underscores an important point about the management of public pensions. Even funds that appear to be relatively stable can quickly find themselves in trouble if the plan administrators fail to deal with pension debt in a responsible manner. For example, the funded ratio of Austin's pension system, which includes the Austin Employees' Retirement System, the Police Retirement System, and the Austin Fire Fighters Relief and Retirement Fund, has dropped by nearly 20 percentage points in just eight years.

3 The American Academy of Actuaries. (July 2012). "The 80% Pension Funding Standard Myth." Retrieved from https://www.actuary.org/files/80_Percent_Funding_IB_071912.pdf.

Given that Austin's pension debt is more than two times larger than its general fund revenue, local leaders should take the system's current 67-percent funded ratio as an indication that the city could face significant pension problems in the future. In fact, a closer look at financial reports reveals that the city's two largest plans, the Police Retirement System and the Employees' Retirement System, are only 63 percent funded, which is a cause for concern.

Graph 1. Austin's Pension Debt Tripled Between 2007 and 2015



Source: Authors' calculations; Employees' Retirement System, Police Retirement System, and Fire Fighters Relief and Retirement Fund comprehensive annual financial reports; Employees' Retirement System, Police Retirement System, and Fire Fighters Relief and Retirement Fund actuarial valuation reports; "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board; Center for Retirement Research at Boston College, Public Plans Data; and Bureau of Labor Statistics. Note: Adjusted for inflation.

One of the key problems with the system is that the city failed to pay its pension bill in full to the employees' plan during the mid to late 2000s. As the city's workforce grew, the cost of providing municipal workers' benefits alone tripled. At the same time, the plan's debt increased by 200 percent in a decade. And although local leaders put significantly more money into the employees' fund each year, it was still not enough to adequately fund the plan. Between 2003 and 2011, the city underfunded the plan by about $170 million. While the city has made its contributions in full during the past several years, the increase in funding has not made up for years of poor financial practices. Like making the minimum payments on a credit card, this means that it will cost the city much more to pay off the debt in the long run.

The underfunding was compounded by the fact that Austin pursued an increasingly risky investment strategy as the pension debt and benefit costs grew. At 7.5 percent, the city's assumed rate of return for the employees' retirement plan is nearly three times higher than the risk-free rate of return, which means that it is expecting the plan to yield returns that it is unlikely to

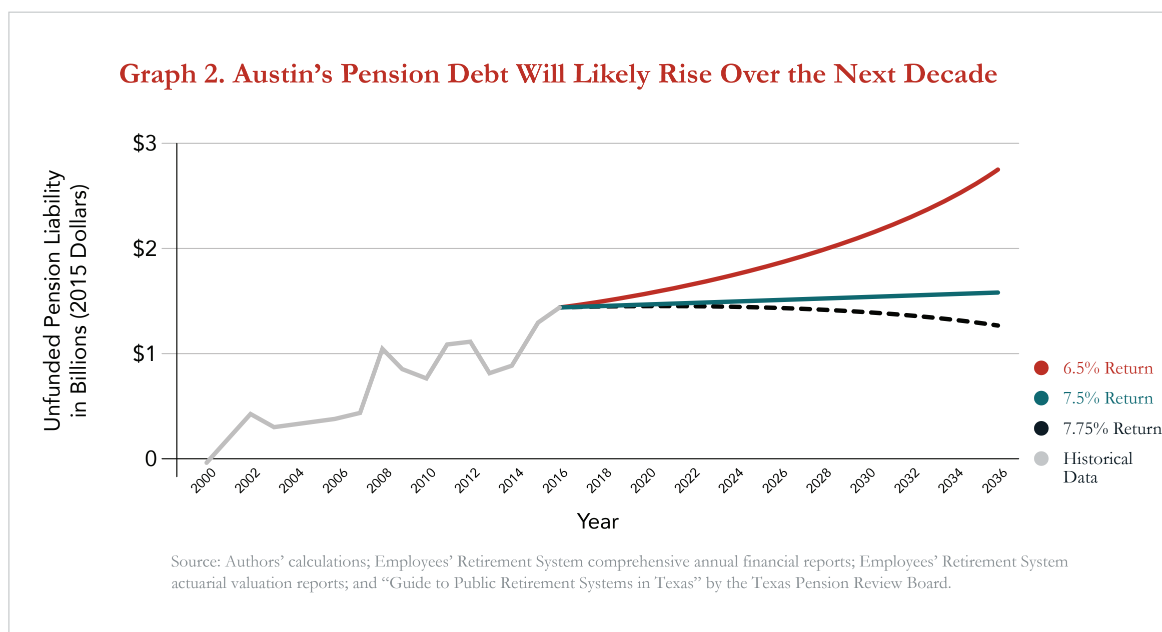
achieve. In fact, in a recent actuarial experience study, investment consultants for the employees' fund estimated that during the next 20 years, the plan has only a 43.3 percent chance of exceeding its current assumed return of 7.5 percent and just a 50 percent chance of achieving a 7 percent return. Moreover, the employees' plan only recently lowered its assumptions to 7.5 percent from 7.75 percent. The police and firefighter funds, meanwhile, continue to use assumed rates of return that are above the national average—7.8 percent and 7.7 percent, respectively.

In an effort to meet these lofty investment goals, administrators of the employees' plan shifted more than 17 percent of the portfolio into hard-to-value, illiquid assets like real estate and alternatives. This strategy has failed to pan out, however, and between 2001 and 2015, the fund averaged returns that were nearly a percentage point or more below its assumed rate. Even these minor fluctuations have led to big increases in the city's unfunded liability, and if any of the plans earn lower-than-expected returns going forward, the pension system could find itself in serious trouble.

Furthermore, since the city relies on rates of return that it's unlikely to achieve in the short or long term, Austin's pension problem could be more severe than local leaders have acknowledged. For example, if the assumed rates of return were lowered to 6.5 percent for each plan, the system's total debt would jump to $2.6 billion.

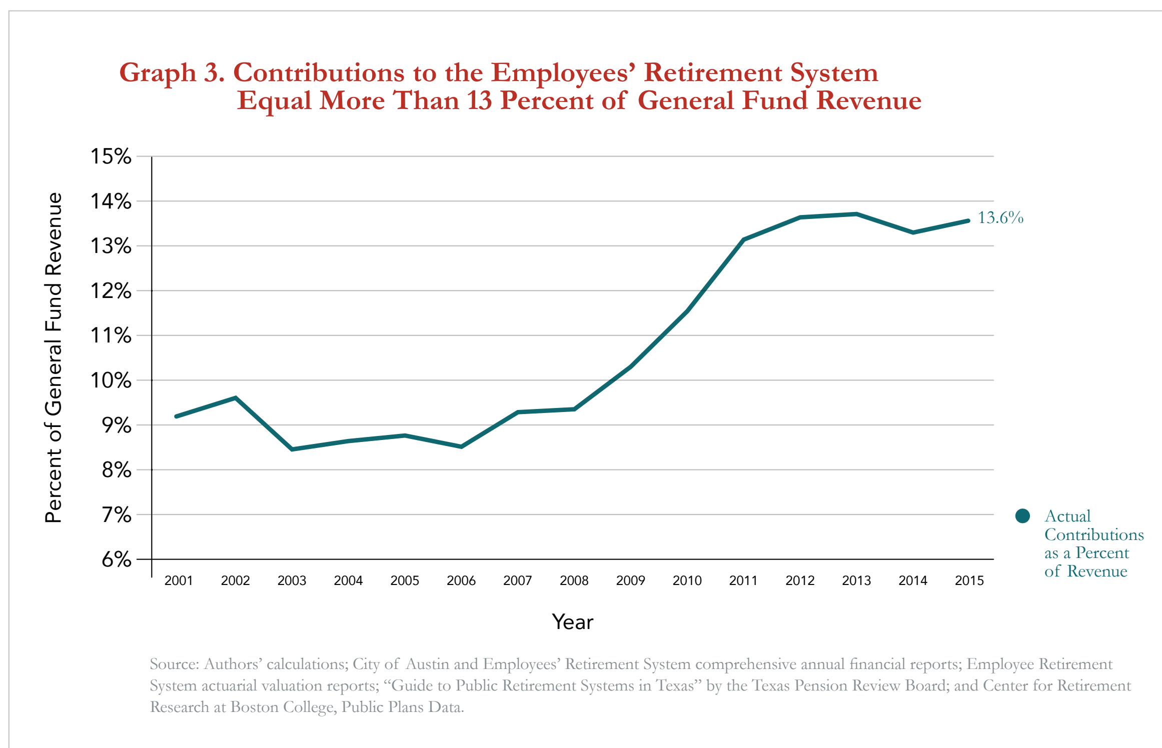
Yet even at its current assumed rate of return, the city is not projected to pay off the debt held by the employees' plan. In fact, projections show that the plan's unfunded liability could rise slightly in the next two decades. What is more concerning, however, is that if the current economic trends continue and the plan's average rate of return does not improve, debt will likely skyrocket.

Graph 2. Austin's Pension Debt Will Likely Rise Over the Next Decade



Source: Authors' calculations; Employees' Retirement System comprehensive annual financial reports; Employees' Retirement System actuarial valuation reports; and "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board.

The city's pension contributions to the employees' plan alone are already equal to 13 percent of general fund revenue, while total contributions to the three plans are equal to nearly 21 percent of general fund revenue. Thus, an increase in pension costs could create significant budgetary challenges, leaving the city with less money to invest in infrastructure improvements and critical public services.



Graph 3. Contributions to the Employees' Retirement System Equal More Than 13 Percent of General Fund Revenue

Source: Authors' calculations; City of Austin and Employees' Retirement System comprehensive annual financial reports; Employee Retirement System actuarial valuation reports; "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board; and Center for Retirement Research at Boston College, Public Plans Data.

The effect of market fluctuations on the financial stability of Austin's pension system highlights a key problem with the way many plans in the state are designed and regulated. Traditional Defined Benefit plans require plan managers to make a number of complex calculations about economic and demographic trends in order to determine the amount of money a government must save now to cover the cost of providing benefits to future retirees.

Texas has few requirements governing plans' funding and investment policies, or the financial information that plans must disclose. This makes it difficult for taxpayers, workers, and policymakers to determine whether pension boards are managing the plans in a responsible manner.

The problem is especially acute for the 13 plans that are controlled by the state legislature, rather than the cities that sponsor them. These funds include Austin's police, fire, and municipal employees' plans, as well as plans in Dallas, Houston, San Antonio, Fort Worth, and El Paso.

While each of these funds is governed under a separate state statute, all of the statutes include provisions that limit local policymakers' oversight and their ability to make changes that could improve the financial health of the plans.

Dallas provides a cautionary example of how the lack of local oversight can lead to serious mismanagement of pension systems, and city leaders in Austin should take note of how quickly pension debt can spiral out of control. Two years ago, the police and fire fund, which is Dallas' largest pension fund, reported that it was 75 percent funded and its unfunded liability was about $2 billion. However, the debt doubled after members approved substantial increases to their own benefits—a move allowed under the plan's statute—and the former plan managers made a series of reckless investments that resulted in big losses.

Given that Dallas does not have control of the police and fire fund, city leaders had limited information about the actions of the plan's former leadership. Policymakers, taxpayers, and workers were caught by surprise when investigative media reports and an extensive independent analysis revealed that the plan was on the brink of a financial crisis. With actuarially determined contributions now at an unprecedented 79 percent of payroll and the fund facing a potential cash shortage, Dallas has few options other than to make draconian cuts to services, reduce benefits for workers, or implement tax hikes.

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The dire situation in Dallas should serve as a warning call for cities across Texas. Austin should not wait for its pension problems to escalate into a crisis. By making reforms now, the city can implement changes that will improve the stability of its pension plans without compromising the level of service it provides to citizens. Left unaddressed, however, the pension debt will continue to rise, placing workers' retirement security and the economic vitality of the city at risk.

Solutions

Austin's city leaders have demonstrated a commitment to upholding the cornerstones of good governance by promoting financial transparency, prioritizing the delivery of high-quality public services, and making reforms to improve programs and policies. Yet in his 2016 State of the City address, Mayor Adler said that as the city continues to grow, it will face a number of important challenges. Chief among them will be the question of how to ensure that Austin is both a vibrant and affordable community.

Without reform, Austin's pension debt will have a direct impact on the city's ability to provide services and invest in infrastructure and public safety. Policymakers will be forced to devote more and more of the budget to pension costs and may also be forced to raise taxes and fees or cut benefits for public workers in order to make ends meet. Thus, any plan to improve the financial stability of the city must address its pension debt.

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Although incremental fixes may help in the short term, going forward, local leaders must make comprehensive reforms to ensure that the city is able to uphold its retirement promises to public workers. The city must take steps to address the plans' underlying structural flaws, including the problems with its funding and investment policies.

1. First, the city must make adequate funding non-negotiable and commit to paying down its current unfunded liability in 30 years or less. The city should also commit to paying down—in 20 years or less—any new debt that is accrued, as recommended by the Society of Actuaries Blue Ribbon Panel on Pension Funding. This will help to ensure that the system avoids costly periods of negative amortization.[4]

2. Second, policymakers must establish prudent and realistic funding and investment policies that take into account the possibility of economic downturns and the government's ability to cover lower-than-expected investment returns.

4 The Employees' Retirement System board has adopted funding and investment policies. The funding policy explicitly states that pension debt should be amortized in 25 years or less. While having these policies in place is positive, the city's actual contributions are set by state statute and do not necessarily align with the pension fund's policy.

3. Third, city leaders should seek control of Austin's pension plans in order to improve oversight and accountability. By establishing local control of the pension fund, the city would also have the flexibility it needs to respond to changing economic or demographic trends.

4. Finally, the city should consider enrolling new workers in plans that are simpler and easier to manage, like a Defined Contribution or Cash Balance plan. Both plans can be designed to provide workers with a secure retirement while better protecting the city's financial interests.

It's important that local leaders take a balanced approach to addressing the pension debt. The burden of paying off the plans' unfunded liabilities should not fall on a single group of stakeholders, and city leaders should engage taxpayers and workers in identifying fair and sustainable reforms that will ensure that the pension system remains financially stable.

Austin's pension costs are rising and could present a serious financial problem in the future. However, there is still time for the city to implement reasonable reforms that will address its funding issues. Austin is known as a city that is committed to finding innovative solutions. It should apply this mentality to solving its pension problems and take action now to protect residents and the city's dedicated public workers.