Economic Analysis

Houston, We Have a Debt Problem

Amanda Augustine / Nathaniel Karp / Marcial Nava

- **Houston's economic outlook is clouded by its increasing debt burden**
- **Lifting the revenue cap has been proposed as a short-term fix**
- **However, changes in structure or conditions of public pensions may be needed to achieve long-term sustainability**

Despite Houston's strong economic performance in the past few years, the city faces significant challenges as liabilities continue to outpace revenues. The gap will be more difficult to shrink unless substantial structural reforms are taken. On the expense side, the city's large unfunded pension liabilities, totaling $3.3 billion to date, are a major contributing factor to its growing debt burden. On the revenue side, Houston's revenue cap on property taxes limits the amount of inflow the city can expect to earn from its single largest source of revenue. The cap links property tax collections to the combined rates of population growth and inflation. In FY2016, Houston hit the revenue cap for the first time since its inception in 2004, forgoing an estimated $53 million in revenue.

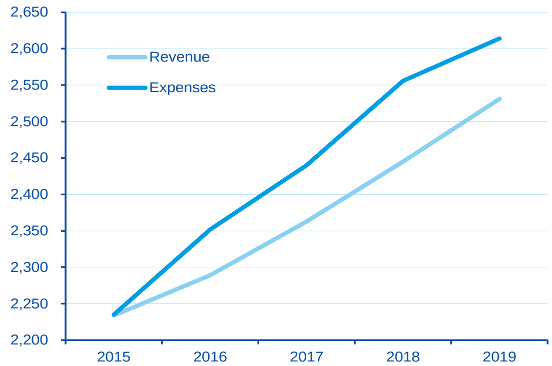
Potential Solutions

Debt management methods, whether on the corporate, municipal, national or personal level, typically fall into one of two categories—raising revenues or lowering expenses.

Raising revenues: Mayor Parker plans to bring changes to the revenue cap before City Council this summer, with the intention of putting it up to voters on the November ballot. Proposed changes consist of lifting the revenue cap and/or hiking property taxes. With the revenue cap in place, efforts to bring in more businesses into the city seem futile, as the number of new office buildings or homes would have little impact on potential revenue stream. Moreover, a hike in the already-high property tax could drive away existing business and residential investment, as companies and their employees could opt to move beyond the city's tax boundaries.

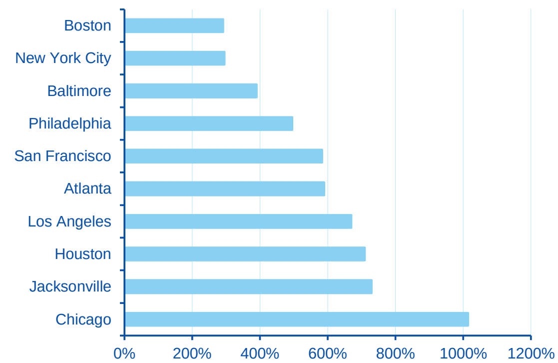
Cutting expenses: Initiatives aimed at lowering city expenses center on pension costs, either through structural changes in the nature of the benefit contract or to changes in benefit conditions, such as retirement age or cost of living adjustments. One proposed structural change is to make public employees' pension funds more similar to a 401k by allowing them to make their own contributions along with the government's provision. The greatest risk to this shift towards a defined contribution plan is that public employees could ultimately end up with insufficient retirement funds. Texas remains one of the few states in which public employees are not covered by social security benefits, and according to a 2010 study by the U.S. General Accountability Office, only 47% of Texas's public employees choose to participate in social security. Another option that could lead to decreased expenditures is adjusting the parameters of benefits, for example, raising the retirement age or reducing cost of living adjustments. Both of these approaches have been implemented in other municipalities, such as Los Angeles and Chicago, but reduce the attractiveness of public employment and expose employees to inflation risk.

Chart 1
Houston General Fund Revenues vs. Expenses
$, millions



Source: City of Houston FY2015 Adopted Budget; Bridging the Budget Gap FY2016-FY2019

Chart 2
Market Value Pension Debt as Share of Revenue
%



Source: Joshua R. Rauh, Why City Pension Problems Have Not Improved, and a Roadmap Forward

Bottom Line

Houston's debt problems did not happen overnight. They reflect both complacency and lack of long-term perspective of the shortcomings in the city's tax policies and public pension system. If the city spirals further into debt, early consequences could include layoffs and decreases in the availability and quality of public services such as libraries and parks. In addition, the city's cost of funding would increase, diverting more resources to service its debt rather than productive uses.[1] The proposed solutions to Houston's debt problems come with tradeoffs of their own and are sure to be the subject of heavy debate during the mayoral elections this fall. Bridging the gap between Houston's revenues and spending may involve serious, structural changes that will take place over long-term. Nonetheless, taking steps to reduce debt now could deter this problem from crippling the local economy.

[1] Last month, Moody's downgraded its outlook on Houston's general obligation debt: https://www.moodys.com/research/Moodys-affirms-City-of-Houstons-TX-Aa2-GOLT-revises-outlook--PR_329444