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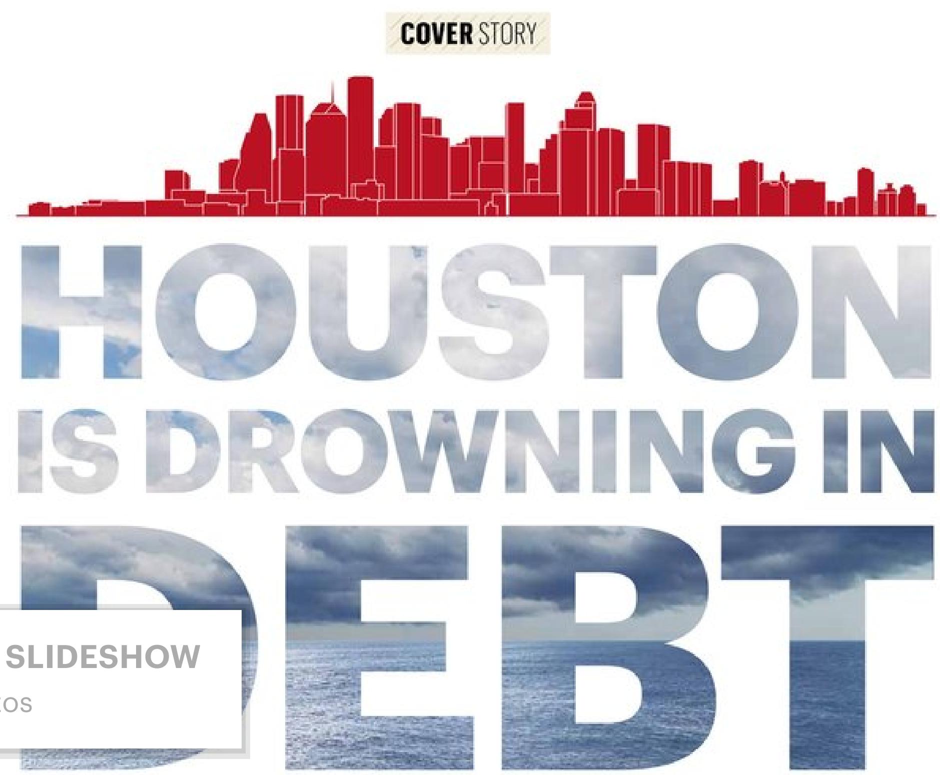
Cover Story

City upside down: How Houston lost control of its wallet



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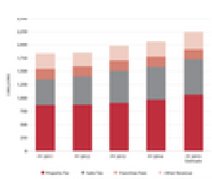
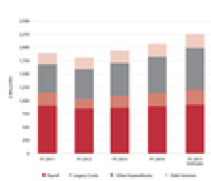
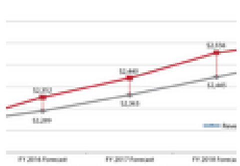
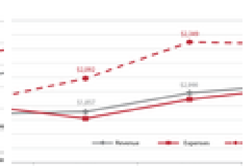
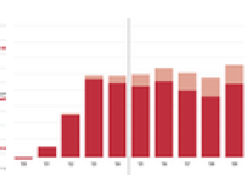

Click through the slideshow to see how Houston's finances have progressed over the years.

By Cara Smith – Reporter, Houston Business Journal
Jul 24, 2015 **Updated** Jul 27, 2015 5:20pm CDT

One of the world's biggest economic hubs is on the brink of a financial crisis, experts say. It's spending far more cash than it's bringing in. Revenue is growing, but not nearly as fast as expenses are. City worker pension costs are through the roof, and there aren't any long-term solutions on the table. Despite all this, many residents think everything is great. After all, it ranks at the top of some global "best of" lists nearly every day, and it's become known throughout the nation as the No. 1 place to work, shop, live, raise a family and make a name for yourself.

But the truth is, Houston is in trouble. It's billions of dollars in debt, and the trouble's been brewing in your backyard for years.

"Cities create the platform for the stage upon which all business is done," said Jim Noteware, a Houston-based real estate developer and former director of Houston's Department of Housing and Community Development. "Cities create the roads, sewers and waterlines, but they also create human infrastructure, and all of those in Houston — like across many cities in the country — are breaking down. It's been happening in front of all of our eyes, and nobody's paying attention."

While Noteware has been a critic for quite some time, new data from the Greater Houston Partnership's Municipal Finance Task Force reveals the staggering extent of Houston's financial turmoil. The GHP has been combing through the city of Houston's finances in cooperation with city officials since June 2014. The Houston Business Journal received exclusive access to the report before it was released to the public, and it reveals serious issues that could have a significant impact on Houston businesses. City officials did not immediately return calls for comment.

Problem 1: Revenue is growing, but not as fast as expenses

In 2011, the city reported $1.84 billion in general fund revenue and $1.9 billion in expenses. That $60 million gap is the steepest difference reported in recent years. But, between 2017 and 2020, the city predicts a cumulative deficit of $484.6 million, according to a presentation to the city's budget and fiscal affairs committee.

The city's general fund is what it sounds like - ‾ it finances some of the city's most critical services: Houston Police Department, Houston Fire Department and other local government employees. Since these services don't generate money, the fund relies heavily on property and sales taxes to pay for them - about 80 percent of the general fund's revenue comes from those two sources.

The fund is vital for a city to keep its pulse. Without it, you'd have a pothole-ridden city in shambles, with no established unit tasked with preventing crime and a defunct governmental core. A city in that shape can't effectively attract new business, retain existing ones or lure professional talent. Ask Detroit.

"(The city of Houston is) following an unsustainable budget path, so we're already getting bad services for our taxes," said Steven Craig, interim dean of the College of Liberal Arts and Social Sciences and economics professor at the University of Houston. "Do you want your car to get fixed once a year or once a decade? That's a real expense."

In large part, the leech on the city's wallet is legacy payments — specifically, $3.3 billion worth of unfunded pension payments.

What's it mean for businesses:

An extreme degradation of day-to-day service deliveries. At its most fundamental level, that means people will see fewer police officers and firefighters. Road and infrastructure repairs have already slowed down, so if you're an employer in Houston, it might get tougher to sell new talent on Houston.

"Businesses are very concerned about their ability to attract talent," GHP President Bob Harvey said. "As we know, talent is all about quality of life. Quality of life is impacted by the quality of city services. The huge progress that we've made in recent years to improve our quality of life and our reputation in the country is being impacted by our roads, I can promise you that."

That same challenge applies to the GHP's primary task of selling employers on headquartering in Houston. When the city's aesthetics gather too much dust, cracks and damage, the partnership has a hard sell to make, and that's not even counting issues beneath the city's surface.

“Frankly, looking at the city’s municipal facilities right now, it’s beyond embarrassing,” said Harvey.

Problem 2: The city’s bloated with $12.9 billion in debt

Houston is buried under a colossal $12.9 billion outstanding debt in short- and long-term debt obligations. Of that $12.9 billion, $9.6 billion is part of the city’s enterprise fund, which is made up of systems that generate their own revenue and have additional taxes dedicated to funding them. The Houston Airport System, the Convention and Entertainment District and the city’s water and sewage systems are part of that enterprise fund. So, there’s an established plan to reduce that debt, but the debt is still there.

The remaining $3.3 billion is Houston’s general obligation debt, which was borrowed for capital expenditures like facilities and construction projects. The city’s debt payments on that $3.3 billion shortfall are spread through 2043, but the lion’s share of the payments will happen before 2021. The debt payments peak in 2018, when Houston will have to shell over $360 million; by 2030, debt payments are either just above or well-below $100 million.

So until 2020, the city’s wallet is going to be historically pinched, and that’s for a plan that solves only one of the two $3.3 billion debt chunks.

The bigger problem lies in the city worker’s unfunded pension fund. Houston hasn’t put enough money into its pension fund, and it’s past the point of no return. To date, the city hasn’t funded $3.3 billion in employee pensions. There’s no plan on the table for funding those pensions — that’s what makes it more toxic than Houston’s $12.9 billion debt.

In all likelihood, the pensions will have to be paid from the city’s general fund, the GHP report said. That spells a further downgrade in city services.

“Everybody blames pensions as the big issue, and it is,” Noteware said. “These (municipal) workers think they made a deal with the city, but the city is not a credit-worthy borrower.”

In 2014, Houston paid 25.5 percent of the Houston Police Department’s payroll toward its pension fund - basically, if a police officer was hypothetically paid a $100 salary, the city took $25.50 of its own (or borrowed) money and put it toward the pension fund. That's an exorbitant contribution; the average pension payment should hover around 11 percent to 13 percent per payroll in a healthy municipality, GHP officials said.

A big catch of pension payout is that the city isn't getting anything in return. It's an investment that yields nothing, and the debt it's causing could potentially ransack the city's credit rating.

"The city is going to be paying tax money now for ... services that were delivered five, 10 and 50 years ago," Craig said. "As a taxpayer, that means that I'm going to be paying money and getting nothing back. On average, nobody likes to do that. The city is calling me up on the phone and saying, 'Please, send me $100; I'm not going to give you anything for it.'"

What's it mean for businesses:

Houston's residents aren't getting any return on a large sum of their taxes. For businesses in a competitive environment, any investment that doesn't yield a return is almost always unjustifiable.

Companies usually respond faster than residents when it comes to tax code changes, so that means that more companies will relocate their headquarters outside the city's taxable boundaries, Craig said.

"Business leaders outside of Houston are saying, 'Well, as long as those silly competitors are in Houston, I have a cost advantage over them,'" Craig said. "If you're a business leader in Houston, you're thinking about looking to get your firm out of the city."

It's harder to sell a business on staying in the city limits, Harvey said. Instead, businesses can move their headquarters to one of the numerous counties with gentler tax codes less than 20 miles away. When business moves outside the city, experts largely agree that its workers do, too.

"Two years ago, I spoke with an (executive at Ernst & Young), and he was recruiting and trying to bring companies into Houston," Noteware said. "In 2013, the company recruited 20 very large, new employers in the Houston region. None of t hem are located in Harris County. They all went to Brazoria County, Montgomery County, Waller County and other counties. We're not building our own job base."

Problem 3: Taxes are already high, and raising them isn't a sustainable solution

Property tax is Houston's largest single revenue source. Between 2012 and 2014, the city earned a collective $2.7 billion in property taxes. During fiscal year 2015, the city of Houston estimates it will scoop up over $1 billion in property tax. Houston, like all Texas cities, doesn't have an income tax, so our relatively high property tax rate is a fair trade-off for businesses that come to Houston, experts say.

Despite the city's record-high revenues, Houston is in record-high debt. In a scenario where businesses relocate out of Houston at a faster rate, experts agree that those businesses' workforces will follow them into the suburbs. That's when the city might be pressured to hike up the already high property tax.

Another challenge that Houston faces is its credit rating. On July 2, New York-based Moody's Investors Service gave Houston a "negative" outlook. It didn't officially downgrade the credit rating, Harvey said, but it showed that a lower credit score isn't a foreign possibility for the city if it fails to rein in its expenses.

"If the next thing that Moody's does is a downgrade, then immediately, all of our debt is more expensive. So, that's more pressure on your budget. Will there be huge pressure to raise taxes? Absolutely," Harvey said. "It's a very common path for cities to take. They take that path until their business community revolts. At that point, forget business attraction — what you'll see is business exits."

What's it mean for businesses:

If Houston even mentioned the possibility of a property tax hike, companies could begin the exodus out of Houston's city limits, said Harvey.

"The worst thing we can do right now is signal that the city is going to raise its taxes to deal with this issue and basically tell businesses that it's going to be less and less favorable to do business in the city limits," Harvey said.

Noteware said he's spoken to a number of Houston commercial property tenants, and they're already "buckling" under the weight of Houston's high property taxes. The two basic solutions for a colossal debt are to either lower expenses or raise revenue, and the city's one malleable tool that raises revenue is taxes. But, even that likely wouldn't be enough.

"It is mathematically impossible for the city to fulfill all of its obligations. It's not just that the existing day-to-day operations are unsustainable," Noteware said. "But, when you look at the total debt that has been accumulated ..., it's in excess of $10 billion. The city's general fund is only $2.2 billion. The city could collect taxes for the next few years and pay nothing out. I mean, (it could) just turn out the lights and stop."

Now what?

The first step of solving a problem is acknowledging its existence. If the people holding the city accountable are aware of its short fallings, that puts Houston in a critical position of control. Now, it's leadership's responsibility to pull Houston out of the depths.

"Right now, public attention is the most important thing," Noteware said. "Public awareness and public attention."

Politically, the timing of the data's release is significant. With Mayor Annise Parker relinquishing her role as Houston mayor in January, there will likely be a slew of hopeful successors preaching fiscal reform. To date, there's around half a dozen of those hopefuls gearing up for campaign season, including Rep. Sylvester Turner (D-TX) and Ben Hall, who lost the mayoral election to Parker in 2013.

In bringing this information to light, the GHP faced a unique challenge. For an organization the job of which is to recruit businesses to Houston, detailing the city's fiscal floundering is going to make that mission harder to achieve.

"That's one of the issues we face as a partnership — bringing this issue forward. We think it's critical that the city address these issues now and that we don't continue to defer this issue," Harvey said. "But, by bringing this issue forward, it's going to get more local and national publicity, and it's going to be more of a requirement that we act. You can't raise this issue and not act, because the whole country's going to be saying, 'What did they do?'"

"We've gone over the edge and we're sliding down into the pit. But, we haven't slid down that far. Can we crawl out? Maybe, but we have to get on a sustainable budget path now, which we're not on." – **Steven Craig, interim dean of the College of Liberal Arts and Social sciences and economics professor at University of Houston**

"We've got to get people to stop and reflect on the service degradation they're already seeing and have them realize that it's not an anomaly, it's a trend, and it won't change unless we address the … budget." – **Bob Harvey, president of the Greater Houston Partnership**

"The real consequence is that the population is declining dramatically – people leave the city. Those that are left will encounter severe social and economic pain, and that's what's going on in Houston right now." – **Jim Noteware, Houston-based real estate developer and former director of Houston's Department of Housing and Community Development**