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EYE ON THE NEWS

Pension Collapse in Big D

The retirement fund for Dallas's public-safety workers is nearly ruined.

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When Detroit filed for bankruptcy in 2013, the city's emergency-financial team said that high levels of retirement debt could prevent them from rescuing the Motor City's finances. Detroit had been in economic decline for decades, and the pension problem—including billions of dollars in bonuses handed out while the city was hurtling toward insolvency—was just one part of the depressing financial picture. Dallas, by contrast, has been one of the fastest-growing American cities in recent years. Becoming a magnet for investment and opportunity, however, hasn't protected the Texas city from experiencing its own Detroit-style financial crisis. Dallas's retirement system for cops and firefighters combines many of the features that have nearly sunk state and local pension plans around the country. Things got so dire over the summer that retirees began pulling their money out of the system. It's the first run on a government pension plan in recent memory.

Dallas created the police and fire plan in 1916. The system's trustees eventually persuaded the state legislature to allow employees and pensioners to run the plan. Not surprisingly, the members have done so for their own benefit and sent the tab for unfunded promises—now estimated at perhaps $5 billion—to taxpayers. Among the features of the system is an annual, 4 percent cost-of-living adjustment that far exceeds the actual increase in inflation since 1989, when it was instituted. A Dallas employee with a $2,000 monthly pension in 1989 would receive $3,900 today if the system's annual increases were pegged to the consumer price index. Under the generous Dallas formula, however, that same monthly pension could be worth more than $5,000. No wonder the ship is sinking.

The system also features a lavish deferment option that lets employees collect pensions even as they continue to work and earn a salary. Moreover, the retirement money gets deposited into an account that earns guaranteed interest. Governments originally began creating these so-called DROP plans as an incentive to encourage experienced employees to keep working past retirement age, which in job categories like public safety can be as young as 50. In Dallas, the pension system gives workers in the DROP plan an 8 percent interest rate on their cash, at a time when yields on ten-year U.S. Treasury notes, a standard for guaranteed returns, are stuck at less than 2 percent. According to the city, some 500 employees working past retirement age have accumulated more than $1 million in these accounts—on top of the pensions that they will receive once they officially stop working.

To make all of this seem reasonable, the state legislature placed a cap on contributions. Under the cap, cities can budget up to 28 percent of payroll to funding pensions every year. It's a high price, but not nearly high enough to fund Dallas's generous plan, whose officials lately predicted that investment returns would stay above 8 percent forever. Trying to hit that crazy target, the system's trustees began investing in increasingly risky assets. At one point, a startling 50 percent of the fund's money was invested in private equity, real estate, and other volatile assets. Since 2010 alone, the pension system has had to write off nearly $200 million in bad bets, and the system's funding level has slipped below the mark that experts say dooms a pension plan.

Recently, fiscal experts and city officials began mentioning the possibility of bankruptcy. What officials didn't count on, apparently, is that participants in the system, who have the right to withdraw their savings, would actually start doing so once they heard such dire warnings. Retirees have withdrawn nearly half a billion dollars since late summer, sending the system's funding levels plummeting to a dangerous 36 percent. The system's liquid assets—that is, money it can draw on to pay benefits—is down to just $729 million, not much more than the $600 million it needs to keep on hand to assure that it can meet its obligations. That's forced the system to halt withdrawals. It's officially a run.

Fixing this mess without serious reform is almost unimaginable. Even a 40-year plan to pay off the pension debt (twice as long as the Society of Actuaries recommends) would require the city to spend the equivalent of 75 percent of its payroll on pensions alone. Finding the money to do that would require Dallas to more than double property taxes. Even so, a four-decade plan would expose the city to future market crashes that could undermine any recovery. Instead, the city is looking at a host of unpopular changes to the current pension plan, including cutting back cost-of-living adjustments and asking employees to forgo some of the interest they've earned on their DROP accounts. State legislators, who crafted a system they didn't have to fund, would need to approve any changes. Things could get complicated: Republicans dominate the legislature, while Democrats control the city. Still, the prospect of an insolvent Dallas should focus some minds.

Plenty of state and municipal pension systems around the country are in the same situation, but Dallas is the only one facing an immediate drain on its funds. Plans in Chicago, Philadelphia, New Jersey, Kentucky, Illinois, and Connecticut are all less than 50 percent funded. Many have features similar to the Dallas police and fire plan. More than half of large state and local pension boards, for instance, are dominated by employees and retirees, who get to make crucial decisions that taxpayers must fund. Like Dallas's plan, many funds are veering into risky investments in a desperate attempt to improve their finances. Also like Dallas, many of these funds saw such steep declines in their assets after the 2008 financial meltdown that even the second-longest bull-market in American history hasn't dramatically improved their prospects.

During the last year, as the nation has been consumed by a presidential election focused on issues like immigration and trade, our government-employee pension woes have continued to fester. Though it's developed largely out of view, this crisis threatens to undermine our fiscal future. Dallas is a reminder that no magical incantations exist that can make insane pension math suddenly rational.

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