The Real Story Behind the Detroit Pension Fight and What it Means to America's Future

Is Detroit the canary in the coal mine for the 99 per cent?

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When the city of Detroit filed for Chapter 9 bankruptcy in July 2013, America sucked in a collective gasp. This was the largest municipal bankruptcy filing in U.S. history by the amount of debt ($18–20 billion), and Detroit was the largest city ever to officially go bust.

A few months before the bankruptcy, the state of Michigan appointed an emergency manager, Kevyn Orr, to sort things out in Motor City. Orr was given extraordinary powers to rewrite contracts and liquidate some of the city's most valuable assets. The burning question: Who would be responsible for the enormous debt?

Soon enough it became clear that the folks who would be asked to take the hit were not those who created the problems. Just as in so many other parts of the world in the wake of the 2007-'08 financial meltdown, innocent people who did nothing but get up every day and go to work would be asked to pay the bill.

Last week, Orr blasted retirees for resisting his plan to drastically cut their pensions — 26 percent for general retirees and 6 percent for police and fire, and even more, 34 percent and 10 percent, respectively, if they do not agree quickly.

The fight is on. Other cities and states are paying close attention to what goes down in Detroit. But there's something much bigger than bankruptcy going on, and it concerns the future of American society. The answer to the question of who we defend and who we punish when the going gets tough is being written into our future.

If you think of Detroit as far away and unrelated to life in your hometown, think again. The next victim could be your town, your community, your retirement.

We Are All Detroit

More than 50 percent of the children in Detroit live in poverty. Property crime is twice the American average, violent crime three times greater. The statistics are shocking, but they only whisper the misery endured by the people who call this city — once among America's crown jewels, and believe it or not, known as the "City of Champions" — their home.

Robert Johnson, executive director of the Institute of New Economic Thinking, is an economist who has worked closely with the likes of Joseph Stiglitz and has served in Washington as chief economist of the U.S. Senate Banking Committee under William Proxmire.

Johnson, who was my colleague when I served as Media Fellow at the Roosevelt Institute from 2009-2011, is an economist who believes that his work is about more than abstract mathematical models. It's about human experience — the vivid hopes and challenges of ordinary people. When I asked Johnson how he came to think that way, a wistful smile crosses his lips: "I grew up in Detroit."

I sat down with Johnson in his New York City home, where his voice thickened with sorrow as he described the pain of looking on as the thriving city of his boyhood sank into an apocalyptic wasteland of crumbling buildings and bewildered people who mostly played by the rules but saw their lives "compressed and crushed."

He recalled for me the Detroit of the 1960s, a great engine of the American economy and the cradle of many of the country's most illustrious political figures, like Representative John Dingell (whose district started out in Detroit and gradually moved to the western suburbs through redistricting). It was also a cauldron in which the great currents of America's deepest conflict swirled: the deadly race riots of 1967, the labor wrangling of the UAW and the Teamsters, the turmoil of the Vietnam War, and the drugs that flooded the city in the wake of deindustrialization.

Johnson reflects upon the work of his friend, john a. powell of Berkeley, a scholar of American culture who explores how we perceive some people and communities as "others." Many things can be the basis of otherness, like race, or economic status, or gender. When we decide something is other, we absolve ourselves from having to care about it. Detroit, as Johnson explains, has become America's urban other. As a city is liquidated for the creditors, the victims are blamed, the people become traumatized, and the trust in American institutions breaks down. Johnson's work has shown that far from being a necessity, the decision to cut the pensions of teachers and other public workers is a choice — one that will hurt both them and future generations. As he talks about Detroit, Johnson eshews the antiseptic terms common among economists, pouring out visceral words like "pain," "crushing" and "gut-wrenching" to describe what's at stake for all of us.

"Detroit is the canary in the coal mine of America," Johnson says. "It's becoming more and more evident that you can't count on social institutions, or your fellow citizens, or your money managers, or your healthcare system." Detroit is not an isolated case, he cautions, but will serve as a precedent for how the country works in the future. When the weak and vulnerable are asked to pay for our sins, we will all pay in the end.

The Real Pension Story

At a recent conference on pensions convened by the Roosevelt Institute, Johnson, along with Nobel laureate Joseph Stiglitz, political scientist Thomas Ferguson, economists Lisa Cook, Dean Baker, and others gathered to explore the meaning of America's so-called pension crisis and its alarming connection to the country's political underbelly.

To understand this story, first you have to understand the truth of what is happening with pensions across America. Media accounts, often influenced by the campaigns of well-funded organizations and individuals like billionaire anti-pension activist John Arnold, have too often promoted the false image of a widespread crisis in which overpaid public workers have been promised unaffordable and bloated pensions. That's far from reality, Johnson's work shows. In a new paper that will serve as an antidote to a distorted national narrative, he makes several facts clear:

1. Pension underfunding is not widespread. Despite a devastating Wall Street-driven financial crisis which decimated sales, property and state income tax receipts and which led to big cuts in federal aid, many American cities and states have managed to keep their pensions reasonably healthy. In fact, gross underfunding is concentrated in certain states, such as Illinois and Kentucky, and in cities like Chicago. These areas seem to have a few things in common, such as poor governance and unreliable public officials who have mishandled funding. Outright corruption is also common. Detroit's government would certainly win no prizes for responsible governance, and its pension funds' accounting practices were less than perfect, but as Johnson reports, as of 2012, the "funding ratios" (actuarial assets divided actuarial liabilities) of the city's two big pensions funds stood at 99.9% and 87.1 respectively. That's hardly the emergency many media accounts portray.

2. State and local employees are not overcompensated. Johnson explains that the widespread perception that public workers are overpaid is highly exaggerated. Citing studies by economist Alicia Munnell and others, his paper shows that at the lower levels, overall rates of pay vary little between workers in the public and private sectors. At the higher levels, public workers actually make *less* than their public sector counterparts. Cases of overcompensation exist, but they are not the norm and don't significantly contribute to underfunding problems. Overcompensation clearly did not cause the pension crisis in places like Detroit, where levels of staffing and pay per employee are well under large Midwestern cities like Cleveland and St. Louis.

Instead, Detroit's finances were done in by three developments that have zero connection with city employees. First, in 1998, a Republican governor pressured the city to cut income taxes in exchange for $333.9 million annually in increased state revenue sharing for nine years. In 2002, after Detroit had cut its tax rates, the state partially reneged, over time opening a huge cumulative hole in the city's budget.

In 2010 Detroit lost $24 million more a year when its share of the state's sales tax revenue fell as a result of the 2010 Census. In fiscal year 2012, the state administered a final blow: the state legislature chopped an additional $43 million in revenue sharing to the city. As Johnson summarizes, "Between 2010 and 2013 over 47.8% of the total decline in city revenue was a result of the decline in state transfers to the city of Detroit. When Detroit went over a cliff into bankruptcy the state could rightly be accused of providing a major shove."

3. Underfunding is linked to unrealistic expectations of returns. One of the key reasons pension problems have developed has to do with how future returns on funds are assessed. Accounting tricks can get you the results you want, and political pressures often cause pension stewards to play around with the numbers. In technical terms, it matters whether you use something called a high discount rate or a low discount rate to determine returns.

As Joseph Stiglitz has pointed out, if you decide to care about something in the future, you make plans assuming that returns will be low, and you use a low discount rate. But if you decide you don't care about something, you use a high discount rate, which allows you to project high future returns and lets you off the hook for investing in the fund right now. Pension stewards have often based their projections on periods of unusually high stock market returns, and have therefore avoided making the payments necessary to keep funds healthy.

4. Chasing big yield leads to big problems. Where pensions are in trouble, stewards often try the economic equivalent of a Hail Mary pass: They pour large sums into alternative investments in risky assets. Investments of this sort—handled by hedge funds, venture capital, and private equity—have risen sharply since the 1980s. They now constitute 20 percent of public pension fund allocations, despite the fact that fees are high and returns are often subpar — even disastrous in 2008 and after. The huge fees tempt the firms pushing these investments to create all kinds of questionable incentives for pension stewards.

Pension funds rely heavily on a vast corps of advisers, whose advice has been shown in academic studies to add no value at all. Considering, as Dean Baker and Thomas Ferguson commented, that many city and state pensioners do not receive Social Security, it is scandalous that pension managers chase high yields through high-risk assets as opposed to prudent investment in index funds, which have low fees or no fees at all.

Not surprisingly, another disastrous blow to Detroit's finances came with a ridiculous derivatives deal connected with a special financing offer. As Johnson explains,

"The Detroit facts are really quite simple. The revenue losses have resulted from declines in real estate values, loss of income and loss of sales volume attributable to the crisis emanating from Wall Street after 2008. A drastic cut in state revenue sharing from the state of Michigan to Detroit in 2012 occurred on the back of previous cutbacks from the state to the city over nine years. The coup de grace was the derivatives transaction that led to diminished 'other revenues' from the Detroit Water and Sewage Department and a swaps termination penalty that led to marked increases in cash flow demands on the city of Detroit."

5. Big money politics and corruption are major culprits. As Thomas Ferguson has noted, pension underfunding and corruption go hand in hand: areas which have seen pension crises tend to have high rates of corruption, as measured by such indicators as the number of public officials who wind up in prison. Pay-to-play schemes are rampant, and reports of bribery, such as those revealed in Detroit, are common. Even in the absence of corruption, big money politics has a major influence over how pensions are managed and allocated — a major reason why campaign finance reform is urgent. As Fergusonobserves, local and state politicians are relying more and more on Wall Street and other anti-pension business interests.

6. Cutting pensions is a choice, not a necessity. As Johnson and others have noted, there seems to be a discrepancy in how the sanctity of contracts is viewed in America. When it comes to the bonuses of AIG executives after the financial crisis, we were told by experts and pundits that contracts must not be broken, and that taxpayers should foot the bill to avoid breaking this fundamental trust. But in Detroit or Chicago, we are told that the contracts of pensioners are not really worth the paper they're written on. The difference? AIG executives are powerful and well-connected. Pensioners are not.

There are resources to meet pension obligations, if only politicians could make decisions in the interests of

ordinary people, rather than the 1 percent who do not wish to see their taxes raised. Johnson further notes that where pension shortfalls exist, they are far smaller than giveaways to corporations.
7. Decisions made now have far-reaching implications. Johnson finds that among the key themes in the pension discussion are what our choices say about the dysfunction in America politics and the kind of society we are creating for the future.
High-quality workers are attracted to decent-paying jobs and promises they can rely upon. When you cut the pensions of teachers, for example, you can’t attract the highly educated workers needed to fill these jobs, and the quality of education suffers. This means that it’s not just public workers who suffer when their pensions are cut, but the children who rely on schools and the businesses that rely on a well-maintained, thriving city. It is also likely, Johnson warns, that overall compensation in the private sector will be driven down, and inequality exacerbated if public pensions are chopped. All of these factors, he points out, only serve to increase the instability of the overall economy and society.
Stiglitz added an important consideration: that once any major pension system is revised shotgun-style, employees everywhere will doubt the value of their contracts and over time leave in droves. How does that bode for America's future?
Detroit is a city being looted and stripped bare. If we decide that those who are weak and vulnerable will be sacrificed to protect the wealthy and the powerful, then no one is safe. When promises are made, but then broken, a “train wreck is set up,” as Johnson puts it, and emergency manager Kevyn Orr appears to have his foot on the gas.
Johnson ends his pension study with a lyric from the great jazz artist Gil Scott-Heron, who wrote a haunting song about a partial nuclear meltdown that occurred in Detroit in 1966:
“That when it comes to people’s safety
Money wins out every time.
And we almost lost Detroit this time, this time….”
If we don’t do the right thing in Detroit, Johnson warns, we might just lose America this time.

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