Mitchell's Musings 1-24-11

In the *Los Angeles Times* of January 18, the columnist who covers consumer affairs opened an article with the following introduction:

The reaction of Claremont resident Randy Scott was typical of the many e-mails I received last week after reporting that Southern California Edison wants to jack up people's electricity rates in part to cover its pension losses in the stock market. "Unbelievable!" he said. "How can the PUC even approve this request?"

Source: http://www.latimes.com/business/la-fi-lazarus-20110118,0,1032274.column

There are several things to be said about this article but one is that the complaints about public pensions have now spread to private pensions, albeit here a pension of a private regulated utility. So let's talk about pensions and pension funding and about state and local finance. But let's do it in reverse. And then let's talk about public opinion and its molders.

State and Local Finance

A longstanding principle of state and local finance is that while borrowing for long-term capital projects is OK, it is bad policy to borrow for ongoing routine governmental expenditures. Put another way, you shouldn't be paying for the current expenses of the fire department by borrowing. There are various rationales for this position. Perhaps the prime reason for not borrowing to pay current expenses is that if you do so on a regular basis, your debt will rise to the point where you can no longer borrow. In short, paying for current expenses by borrowing is unsustainable, although it might be done for a short time. Another notion is that long-term capital projects will benefit both current and future users and that therefore, stretching out the payments so those in the future pay "their" share is appropriate.

(Let's not get into *federal* government financing here which has other elements including macroeconomics and the power to create money. We are talking in this musing about state and local governments that do not have such responsibilities and powers.)

Pensions and Pension Funding

Underfunding a defined-benefit pension plan is essentially borrowing to pay current expenses, in that case the current remuneration of employees. The pension payments to employees are promises to pay annuities in the future. If adequate funding is not put away when those employees' services occur, essentially, the result will be that future taxpayers will have to pay for services they may not have been around to receive. In addition, the growing value of pension promises can eventually become unsustainable unless adequate funds are put aside when the benefits are earned.

Pension *aficionados* have a concept called the "normal cost" of a pension. The normal cost is essentially the value of the incremental liability incurred by the plan each year as active employees accrue service credit. Put another way, the normal cost is the value of each year's future promises. To keep a plan roughly fully funded (so that the employing entity is not paying for current services by *de facto* borrowing), the normal cost – however it is split between employer and employee contributions – needs to be flowing into the fund.

As readers of this musing will likely know, defined-benefit pensions determine monthly benefits by age, service, and earnings history of the employee through a formula. As such, the employer takes on the risk of having adequate funding when the benefits must be paid. Employees do not invest the funds nor are they subject to risks in financial markets directly. The promise to them is the pension formula. How the employer acquires the resources to meet those promises is not of concern to the employees.

Defined-benefit pensions can be thought of as a pension plan that comes with pension insurance. In contrast, particularly in the private sector, defined-contribution plans simply give the employee a tax-favored savings account in which the employer places a set contribution. The formula is the basis of the contribution, not the benefit. The employee invests the monies contributed in various alternatives (a stock fund, a bond fund, etc.) and come retirement time, he/she has an amount of cash that reflects his/her skill (luck?) in investing. What is in the plan on retirement will depend on the condition of financial markets at that moment and what is in the employee's portfolio. What kind of annuity the money in the plan on retirement might buy will depend on the portfolio value and on such variables as the then-prevailing interest rate. There is no pension insurance in a defined-contribution plan. But, of course, there cannot be underfunding since no future promises were made.

Most striking about the article cited above is that it tells the reader nothing about the history of the funding of the Southern California Edison plan. Was there a policy of deliberate underfunding? Or is the employer acting responsibly in its current funding decision? There is nothing in the article that suggests there is anything underhanded going on.

What seems to upset the journalist who wrote the piece is that many Edison customers don't have defined-benefit pensions with their characteristic of pension insurance. I am sure that Edison employees have a health insurance plan that also protects them against another form of risk, i.e., sickness and injury. But the area served by Edison will have many electricity customers who lack job-based health insurance. (Southern California residents have a lower-than-national-average rate of coverage by such insurance.) So is it also an outrage that Edison customers, through their electric bills, are paying for health-risk coverage of Edison workers?

When you push the argument to the extreme, the ultimate conclusion must be that no Southern California Edison customer should pay for the costs of any Edison employee who earns more than he/she does or who has any condition of work better than the customer. I doubt the journalist who wrote the article – on reflection – would endorse that view. After all, one could easily ask whether any customer of the *LA Times* should "pay for" the costs of the compensating the author if the customer earns less than the author does.

Opinion Molders

There was a time in California, as in other states, that key newspapers and their owners were major opinion molders of public opinion and were major political players as a result. You may have seen the PBS program on the Chandler family a few years ago, the family that for many years owned the LA Times and were big movers and shakers in state and local affairs.

As in the case of other newspapers, the Internet and the changing reading habits of the general public have led to major cutbacks, layoffs, and bankruptcy, at the *LA Times*. Whatever security journalists there and elsewhere may have had is long since gone. Recent years have seen loss of circulation, downsizing, and the diminishment of the *LA Times* as a national newspaper. Its travails are parodied regularly by a website: www.notthelatimes.com that whose homepage looks similar to the actual www.latimes.com, but ridicules the paper. (And even the parody website now seems to have fallen into Hard Times; its current version months out of date.)

Figure 1 below shows the sorry condition of newspaper employment in the U.S., now down to levels of the late 1940s. But despite their diminished state, newspapers still have an impact on public opinion. Most have moved on to the web and are therefore contributing to public perceptions through that medium. In addition, former newspaper journalists have experimented with blogs or have attached themselves to other internet forums. But job security and good benefits are not likely to part of a typical journalist's labor market experience.

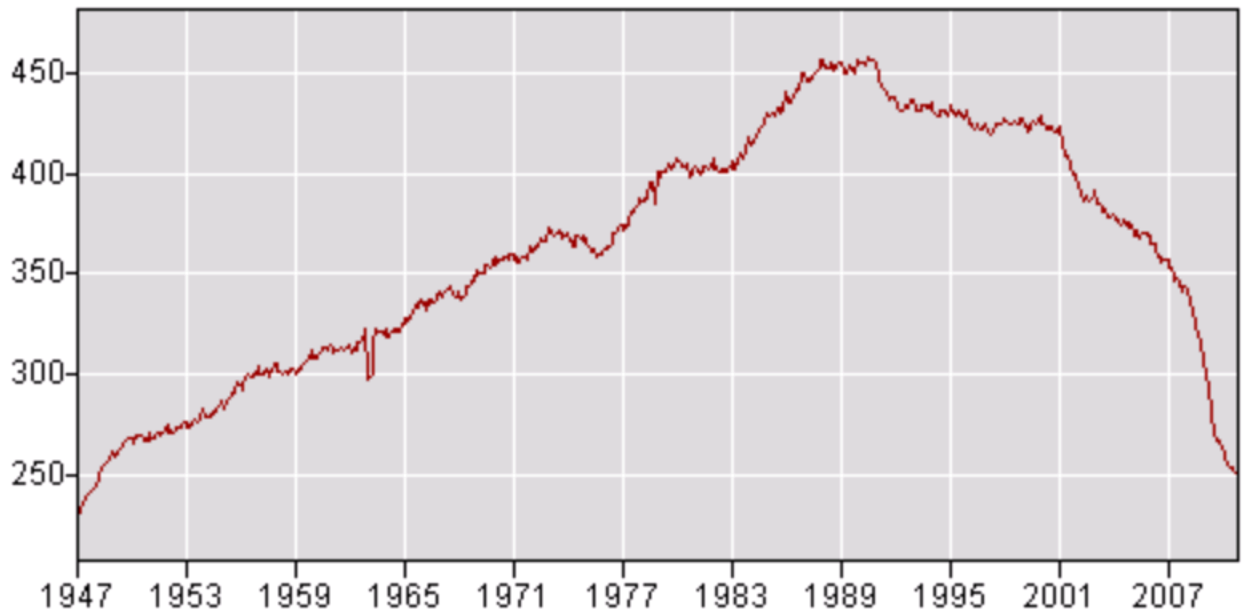
The figure indicates that job growth in the newspaper industry peaked in the late 1980s and early 1990s. But the real slide begins around 2000. Many journalists may have entered the profession, therefore, with expectations that were subsequently shattered. So it is understandable that there should be journalistic complaints about others in the labor force, here utility workers but more often public sector workers, who have been relatively insulated from the Great Recession.

While the reaction is understandable, it is not helpful in determining public policy. Southern California Edison is a regulated utility whose rates must be approved by a state agency. The article that triggered this musing does not tell you whether Edison misbehaved in its pension funding or whether it is acting responsibly. Misbehavior should not be rewarded by regulators. But the costs of responsible behavior should be reflected in utility bills.

I have sympathies for journalists whose career expectations were thwarted. But I also have sympathies for utility workers whose compensation packages include benefits. If their pension fund is not made whole, is that really of benefit to the larger society?

Bottom line: A famous early 20th century cartoon (see below) suggested that if things are bad we resent anyone who has it even a little better. Probably not the best approach.

Figure 1: Newspaper Employment in Thousands, 1947-2010



Source: U.S. Bureau of Labor Statistics

The Masses

"'I Gorry, I'm tired!"

"There you go! You're tired! Here I be a-standin' over a hot stove all day, an' you workin' in a nice cool sewer!"