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TRANSPARENCY: USING FINANCIAL OPENNESS AT THE POSTAL SERVICE TO PROTECT CONSUMERS AND TAXPAYERS

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Enron used questionable accounting practices to inflate reported earnings even as it lost money on new and non-traditional product lines that it hoped would guarantee the future of the company. Unlike Enron and Global Crossing, the Postal Service never tried to create the illusion of huge profits; its goal — which it has failed to meet — is just to break even. Nevertheless, opaque accounting, and sometimes lack of accounting, mask uneconomic, wasteful, and abusive business practices at the Postal Service. In particular, the accounting may hide losses on new and non-traditional product lines that are outside the Postal Service's core business. The Postal Service claims that the key to its long-term health is giving it more power to adjust rates and enter new markets as it sees fit. Given the Postal Service's current lack of accountability and disclosure, that would be exactly the wrong medicine.

One of the biggest temptations for the U.S. Postal Service, and also other government enterprises, is to use socially undesirable cross-subsidies in an effort to expand. At the Postal Service, the customers that can most easily be charged high prices are those whose alternatives are limited by the Postal Service's government-granted monopoly on non-urgent letter delivery. First-class mail users are particularly at risk. By charging these customers too much, the Postal Service can operate at a loss in markets where it faces competition and still break even overall, or come close to doing so. In addition to hurting customers within the postal monopoly, a Postal-Service expansion driven by cross-subsidies has other undesirable consequences. By shifting production from more efficient private-sector businesses to a less-efficient government business, it reduces the economy's productivity. It also threatens taxpayers, who ultimately cover Postal Service costs not met by customers, and unfairly competes with private-sector taxable businesses.

Two General Accounting Office (GAO) studies that looked at the finances of new Postal Service products offer a glimpse of the problem. In 1998, the GAO reported on 19 products introduced in the mid 1990s.[1] The products ranged from Global Priority Mail to prepaid phone cards to bill processing for a credit card company; none were in the Postal Service's core market of non-urgent letter delivery. The GAO found that 15 of the 19 new products had lost money, with cumulative losses of

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$88.4 million on revenues of $266.6 million according to the Postal Service's unaudited figures. In December 2001, the GAO issued a report on the Postal Service's electronic commerce ventures.[2] The GAO found that the Postal Service's "financial information related to its e-commerce and Internet-related activities is not complete, accurate, and consistent," and that the "USPS has not achieved its expected performance" in that area. Although the Postal Service promised that it would not cross-subsidize its e-commerce operations with revenues from other products, the GAO concluded, "To date ... this goal [of avoiding cross-subsidization] has not been met, and it is not clear when this goal will be realized."

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In private-sector businesses, the profit motive furnishes a natural, self-enforcing barrier to cross-subsidization. Private-sector business owners do not want to offer products whose costs exceed revenues because the losses would eat into profits. This check on cross-subsidization is intrinsic to private ownership and the profit motive: even if a business could easily divert earnings from profitable products to finance an expansion into money-losing markets, its owners would not want to do so because that would reduce their profits. To be sure, private-sector businesses may sometimes accept temporary losses on product lines, but that is only if the products are expected to become profitable in the future, with the discounted present value of the expected future profits sufficient to cover both the short-term losses and future costs by enough to earn a competitive market rate of return.

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The incentive to cross subsidize is a direct consequence of government ownership and control and is one of the (many) reasons why state-run businesses around the world have built a reputation for being large and inefficient. Government enterprises are typically expected to break even at best, and chronic losses are often politically acceptable if they are not too big. The break-even mentality permits extensive cross-subsidization: government enterprises can expand by offering money-losing products, while financing the losses by charging more for other products — especially products sheltered from competition by government-enforced monopolies. Even loss-driven expansions are in the interest of the managers of government enterprises because they typically gain higher salaries, more power, and greater prestige as their organizations grow.

Sometimes the Postal Service may not even know whether it is cross-subsidizing a product. Private-sector enterprises usually develop rigorous costing methodologies that they apply in assessing the performance of existing products and planning new ones. After all, a business cannot know how a product is performing financially unless it knows how much it costs to produce the product. In contrast, the Postal Service often fails to develop the cost data on products that private-sector businesses regard as essential. In

December 2001, the GAO disapprovingly noted many examples of "inaccurate and/or inconsistent cost and revenue data" with regard to the Postal Service's e-commerce products.[3] As one example of the failure to track costs, the GAO commented, "[A]lthough some postage revenues from Mailing Online were reported as e-commerce revenue, the corresponding processing and delivery costs associated with this mail volume were not reported as e-commerce costs."[4] Such incomplete monitoring of products' costs both reduces the Postal Service's ability to manage its operations and increases the likelihood of cross-subsidization.

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The Postal Service customers most at risk of being forced to subsidize money-losing ventures are first-class mail users. They pay a disproportionate share of the Postal Service's costs, and their rates have increased three times in the last decade, from 29¢ for a first-class stamp to 34¢ currently, with a fourth rate increase, to 37¢, slated for this June. Many expect the Postal Service to request still another rate hike in 2003. It is ironic that the government-owned Postal Service and its statutory monopoly on non-urgent letter delivery are often defended as existing to better serve these customers. Taxpayers are also burdened. Because the Postal Service is part of the federal government, its surpluses and deficits are part of the unified federal budget.[5] When cross-subsidies reduce the Postal Service's surplus or increase its losses, they add dollar-for-dollar to the federal budget deficit. Because the Postal Service has lost money during most of its history and is doing so again, federal budget deficits have been larger than otherwise.

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Now that the Enron and Global Crossing collapses have emphasized the importance of disclosure, private-sector businesses have moved vigorously to allay investor concerns. For example, companies like IBM, American International Group, and SunTrust Banks quickly pledged to release more financial information in their annual reports, and General Electric increased financial data in its latest annual report by 30% compared to last year.[6]

The Postal Service and other government enterprises should take the same path. They should open their books to the American people, revealing on a regular basis as much information as possible about their expenditures and revenues. While waste and abuse are kept within limits at private-sector companies by the profit motive, pressure from shareholders, the threat of takeover by better managed companies, and ultimately bankruptcy if operations go too badly wrong, those market-based restraints on poor performance are lacking at government enterprises. Government enterprises can compensate, albeit only in part, for the lack of market discipline by telling citizen/voters what they are doing. The idea, which is a basic tenet of the sunshine in government movement, is that government agencies become more accountable and deliver better performance when the sunshine of disclosure enables citizen/voters to spot problems more easily and focus more clearly on what needs improvement.

One important benefit of fuller cost disclosure at the Postal Service is that it would lead to fewer subsidies across products. Sunshine would force the Postal Service to publicly defend charging more to customers within the postal monopoly in order to subsidize non-core markets, which would be a difficult sell. To maximize the visibility of cross-subsidies, the Postal Service needs to make it a priority to develop detailed cost information on each of its products and publicly release the data on a regular schedule.

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Government enterprises' lack of normal market discipline encourages other abuses, in addition to cross-subsidization, that also could be held better in check through fuller disclosure. A problem eventually brought to light by the Postal Service's Office of Inspector General furnishes one example.[7] The Postal Service offers generous bonuses to its managers, supposedly based on superior performance. However, the incentive rewards were tied to net income, and that became a problem in the late 1990s due to the Postal Service's crumbling finances. The Postal Service's management responded by adding a "revenue adjustment" to its bonus computations, starting in 1998. According to the Inspector General's report, the adjustment enabled the Postal Service's management "to increase revenues [for purposes of calculating bonuses] by $4.9 billion [compared to actual revenues] for fiscal years (FY) 1998 through 2000. This resulted in program participants earning $805 million in incentive awards for that period, while the Postal Service experienced steeply declining profits. Without the adjustment ... incentive awards would have been negative." If the Postal Service had been required to explain openly and from the start what it was doing with its bonus program, its cooking of the books might have attracted attention sooner and been prevented.

In the past, the Postal Service has often blamed its financial woes on the regulatory constraints imposed on it as a statutory monopolist and a government-owned enterprise. Among the "reforms" the Postal Service has long sought from Congress are: more power to set its rates, greater flexibility to alter rates at its discretion among products and customers, and enhanced ability to expand into competitive markets. With modifications, these Postal-Service-requested changes found their way into proposed legislation introduced between 1996 and 1999 by the chairman of the House Postal Service Subcommittee. Although the bills, often referred to as H.R. 22, contained provisions that were supposed to guard against cross-subsidization, the supposed protections almost certainly would have proven no match for the urge to cross-subsidize. Fortunately, H.R. 22 did not advance beyond the House Postal Service Subcommittee.

In reality, the fundamental reason for the Postal Service's deteriorating finances is difficulty controlling its costs. Legislation that increased the Postal Service's authority to expand and change rates would do nothing to restrain costs. If anything, such new powers would worsen the Postal Service's financial problems by distracting it from cost containment and allowing it to offer more products that would probably lose money. A sounder approach for the Postal Service is to redouble its efforts to lower costs and raise productivity. Financial openness, including detailed information on product costs, can assist in the effort by increasing the visibility of costs and the accountability of management: when problems are readily seen, the pressure to fix them increases. Moreover, financial disclosure is a policy the Postal Service can adopt on its own initiative. Because doing so would be in the public interest, the Postal Service's management should take this step promptly. Similar sunshine-in-government initiatives would also be good public policy at other, smaller government enterprises.

As long as the Postal Service remains a government-owned enterprise with a huge statutory monopoly at its core, safeguards against cross-subsidization should be strengthened. The Postal Service should be restricted as much as possible to its core market of first-class and standard A (formerly third-class) mail delivery. The less it intervenes in competitive markets, the less opportunity it will have to lose money in those markets and the less it will reduce the economy's productivity and growth by displacing more efficient private-sector businesses.

The Postal Service suffers from high costs despite hidden government subsidies that save it hundreds of millions of dollars yearly in taxes and other expenses compared to what normal businesses must pay.[8] Among its advantages, the Postal Service borrows directly from the U.S. Treasury's Federal Financing Bank at favorable interest rates; it has never paid interest to the U.S. Treasury on the billions of dollars of assets it received from the old Post Office Department in 1971; it pays no state and local property taxes on its real estate and other assets; it pays no state motor vehicle licensing fees and is immune from parking tickets; its products are exempt from state and local sales taxes; and if it ever again earns profits, it enjoys a blanket exemption from all income taxes.

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Endnotes

1. U.S. General Accounting Office, "Development and Inventory of New Products," GAO Report No. GAO/GGD-99-15, November 1998.

2. U.S. General Accounting Office, "U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections," GAO Report No. GAO-02-79, December 21, 2001, accessed at www.gao.gov/new.items/d0279.pdf.

3. *Ibid.*, p. 12.

4. *Ibid.*

5. This fact is often not realized because, by law, the Postal Service is labeled "off budget". The federal government, however, includes the Postal Service in its unified, or total, budget. Federal budget documents explain that the unified federal budget, which has "on budget" and "off budget" components, is "the foundation for ... [the federal government's] budgetary analysis and presentation." (U.S. Office of Management And Budget, *Budget of the United States Government*, *Analytical Perspectives, Fiscal Year 2003* (Washington, DC: U.S. Government Printing Office, 2002), pp. 383-384.) The Congressional Budget Office concurs that the Postal Service's expenditures, revenues, and surpluses or deficits are included in the unified federal budget. Social Security is also, by law, classified as "off budget". (*Ibid.*) Thus, in a government-accounting sleight of hand, the federal government labels "off budget" both its largest tax-and-transfer program (Social Security) and its largest quasi-business enterprise (the Postal Service), but counts them in the unified, or total, federal budget.

6. Rachel Emma Silverman, "GE's Annual Report Bulges With Data In Bid To Address Post-Enron Concerns," *The Wall Street Journal*, March 11, 2002, p. A3.

7. Office Of Inspector General, U.S. Postal Service, "Use of the Economic Value Added Concept in the Pay for Performance Program," Report No. LH-AR-02-001, December 5, 2001, accessed at www.uspsoig.gov/foia_files/LH-AR-02-001.pdf. Also see Office Of Inspector General, U.S. Postal Service, "Economic Value Added Variable Pay Program," Report No. LH-AR-02-001, July 31, 2000, accessed at www.uspsoig.gov/foia_files/LB-AR-00-001.pdf; and Rick Merritt, "Stamping Out Productivity," *Washington Times*, January 9, 2002, p. A17.

8. For estimates of the dollar magnitude of many of the Postal Service's hidden subsidies, see Michael A. Schuyler, *The Anti-Competitive Edge: Government Subsidies To Government Businesses: Case Studies Of The Postal Service, TVA, And Amtrak* (Washington, DC: Institute For Research On The Economics Of Taxation, 1999). The paper also provides estimates for many of the subsidies at TVA and Amtrak.