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THE POSTAL SERVICE'S "TRANSFORMATION PLAN": ONE GOOD IDEA FOR REDUCING LOSSES AND TWO BAD ONES

Introduction

The United States Postal Service (USPS) issued a proposed reorganization plan in April 2002. Called the "Transformation Plan" by the Postal Service,[1] it described three possible structural forms the future Postal Service could take, and three main avenues for action to eliminate current and projected deficits.

The three structures range from: (1) "a Government Agency, offering subsidized residual services not provided by the private sector;" to (2) "a Privatized Corporation, a competitive company owned by private citizens" which would contract with the government for basic mail service and be free to engage in any other type of business activity; to (3) the Postal Service's preferred "middle ground" option: "a Commercial Government Enterprise, owned by the government but structured and operated in a much more businesslike manner, with attributes appropriate to the unique role this institution plays in the nation."[2] Among the "attributes" the Postal Service would like to keep are its monopoly on non-urgent letter delivery, its monopoly on home and business mailboxes, its tax-exempt status, and continued access to credit at low interest rates due to the implicit government guarantee of its debt.

The three avenues the Postal Service asserts could be used to reduce projected deficits are: 1) better cost management, 2) participation in more markets to expand volume, which the Postal Service claims would make better use of fixed-cost facilities, and 3) more flexibility and less regulation in setting rates. The first, containing costs, would be the chief avenue open under a "Government Agency" status, while all three would be in play under the other two structural changes.

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The Postal Service's "Transformation Plan" raises many public policy questions, some of which IRET has addressed in the past in studies of government-owned enterprises. Basic tax and economic theory tells us that it is wrong to favor one type of business or economic activity with a low tax rate while subjecting others to a high tax rate, because it creates economic distortions that reduce national income and output. The same holds for subsidies for the production or consumption of certain products.

It has been seen in practice how "government sponsored" entities such as Fannie Mae and Freddie Mac have come to dominate their market segments, nearly freezing out private competition, with only the advantage of an implicit government guarantee of their debt. These entities have become so large that they are generating concerns about the possible misallocation of capital in favor of the housing sector, and the effect they would have on the financial markets or on taxpayers should they get into financial difficulty. The Postal Service would have a double advantage. How much of the economy would the Postal Service take over if it were given free reign with both tax exempt status and federally guaranteed debt?

In light of these tax and economic concerns, IRET will be producing a series of papers that will look closely at the Postal Service's "Transformation Plan" and at the assumptions on which it is based. The hope is that a careful review of each of the arguments and options, undertaken with basic economic and tax theory in mind, will shed light on whether the Postal Service's analysis and conclusions are valid, and allow an assessment of the changes it recommends. The current paper gives a preliminary overview of some of the key issues by commenting briefly on each of the three general avenues for eliminating deficits that the Postal Service laid out in the Plan.

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A History of Losses and Three Suggested Avenues for Improvement

The government-owned U.S. Postal Service and its predecessor, the Post Office Department, have bled red ink during most of the organization's long history. In 1994, the Postal Rate Commission stated bluntly, "According to the Postal Service's own witness...if the Postal Service were a conventional business operation, it would be bankrupt."[3] Although the Postal Service enjoyed a brief turnaround starting in 1995, rising costs almost immediately began whittling down the profits, and deficits returned in 2000 and 2001. Despite the rate hike that will take effect at the end of June, the Postal Service expects continued red ink in 2002, due in part to the lingering effects of the recession and aftershocks from the September 11 and anthrax attacks.

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What, if anything, can the Postal Service do to remedy its financial difficulties? The Postal Service's leaders have offered a number of suggestions in their 450 page *Transformation Plan* that they hope would, if implemented, place the organization on a sound financial footing.

The actions sought by the Postal Service's top management fall into three main categories: find ways to cut costs, expand the government agency by letting it offer more products in competition with private-sector businesses, and permit the organization to alter its prices with less regulatory oversight. Although not mentioned in the Postal Service's current presentation, these are not new ideas; the agency has been advocating them for years.[4] As explained below, better cost management is an excellent idea because it would tackle the main source of the Postal Service's chronic financial difficulties. In contrast, the other proposals do not address the cost problem and, if enacted, would lead to potentially wasteful and abusive expansions of government power.

Better Cost Management

Net income equals revenues minus costs. A business will lose money if it spends more than it takes in. It will suffer losses even if revenues grow over time, provided expenditures grow more. This has been the case most years at the U.S. Postal Service, which since the early 1970s has lost money in approximately two years out of

Table 1
Profits Turn To Losses When Costs Increase Faster Than Revenues

	1996	1997	1998	1999	2000	2001
Total Revenues, * in $ millions	$56,544	$58,331	$60,116	$62,755	$64,581	$65,869
Total Expenses, ** in millions $	$54,977	$57,067	$59,566	$62,392	$64,780	$67,549
Change in Revenues from prior year	*3.7%*	*3.2%*	*3.1%*	*4.4%*	*2.9%*	*2.0%*
Change in Expenditures from prior year	*4.2%*	*3.8%*	*4.4%*	*4.7%*	*3.8%*	*4.3%*
Net Income (Loss), in $ millions	$1,567	$1,264	$550	$363	-$199	-$1,680

* Sum of operating revenue, revenue forgone appropriation, and interest and investment income.
** Sum of total operating expenses and interest expenses.

Data Source: U.S. Postal Service, *Annual Report, 2001*, pp. 48-49.

three.[5] Table 1 shows what happened in the last several years, which is a variation on this pattern. The Postal Service went from a $1.6 billion profit in 1996 to a $1.7 billion loss in 2001 because, while its revenues increased every year, its costs grew faster.[6]

The Postal Service acknowledges in its plan that it has cost problems and says it will try to limit expenditures by boosting productivity and also by paying less for labor and capital inputs (or at least slowing the rate of increase of input costs). However, the agency explains that while it can undertake some measures on its own initiative, others would require legislative changes.

For example, the Postal Service's plan calls on Congress to rewrite the laws concerning how employee wage increases are determined. "Under the current legislation," says Postmaster General John E. Potter, "we do not control our own wages."[7] Lending support to this Postal Service recommendation, an econometric study by Hirsch, Wachter, and Gillula indicated that in the mid 1990s the wages of bargaining unit postal employees were 28% higher than those of comparable private-sector workers before adjusting for skills and working conditions and 34% higher after adjusting for skills and working conditions; looking at total compensation, rich fringe benefits raised the differential in favor of bargaining unit postal employees by another 8%.[8] These findings suggest that the government organization's labor costs are seriously out of line with those of private-sector businesses. Because labor costs are about three-fourths of the Postal Service's total operating costs[9], the cost savings over time from Congressional reform of the wage-determination process could be enormous. Although there is much more to good cost management than slowing the rate of increase of labor costs (and the Postal Service's plan mentions dozens of possibilities), the numbers suggest that this step alone would be sufficient to put the Postal Service in the black within a few years.

Another reason to emphasize cost containment is that there may someday be a sustained drop in the organization's volume and revenues due to increased use by the public of electronic-technology alternatives to "snail" mail. The Postal Service does not claim this has happened yet or that it will occur with certainty, but it is a possibility.[10] (Although revenues are down so far in 2002, the Postal Service expects that to be temporary, with receipts again rising as the recovery picks up steam.) Companies forced to cope with prolonged sales declines know that effective cost management is the best defense.

The added money the Postal Service needs to spend on security in light of the anthrax attacks also makes it important for the organization to rein in its costs where it can.

Does The Postal Service Need To Be Bigger To Be Profitable?

> ***[T]he Postal Service states that revenues from new products would help the organization financially ... [but] the Postal Service has often lost money when it has introduced new products...***

A persistent theme among Postal Service leaders, reiterated in their current plan, is that the organization must expand into new markets if it is to reverse its losses. The attitude that while cost control is important, expansion is what really matters was forcefully expressed several years ago by then Postmaster General Marvin Runyon, "Folks, there isn't much of a future for us if we are only a cost-cutting organization. We also need growth."[11]

The main area into which the Postal Service wants to move is competitive markets, that is, markets already served by private-sector companies. Currently, the bulk of the Postal Service's business is in its core market of non-urgent letter delivery, but it also offers an assortment of competitive-market products, such as parcel post, overnight letter delivery, money orders, electronic bill payment, and pre-paid telephone calling cards. The Postal Service has not been able to venture nearly as far into competitive markets as its leadership would like, however, because of limitations Congress placed on the agency in the Postal Reorganization Act of 1970 (the act which converted the Post Office Department into the Postal Service). The Postal Service's leaders, in the plan they have issued, call on Congress to rewrite the law and loosen the restrictions, saying "a revision of the Postal Service's 1970 charter is overdue."[12]

> ***[I]f the [Postal Service] expansion strategy succeeds ... it will displace more efficient private-sector firms... If the strategy fails, it will be adding new losses to the old ones.***

Unlike cost containment, this is a terrible idea. First, consider the proposal from the perspective of the Postal Service's bottom line. It stretches credibility to claim that this huge enterprise has losses because it is too small. The organization reports that if it were a private-sector firm, it would be among the three dozen largest companies in the world.[13] The Postal Service may need to be reminded of the old business saying that if you lose money on every unit, you are not going to make it up on volume.

In discussing its plan, the Postal Service states that revenues from new products would help the organization financially while almost never cautioning that this would only be the case if the added revenues from expansion exceed the added costs. For the most part, the Postal Service does not distinguish clearly between revenues and net income. The Postal Service should be painfully aware of the distinction — and give it much weight in its planning — because of its long record of rising revenues combined with negative net income.

To be sure, the Postal Service's government status gives it certain advantages compared to private-sector businesses. For example, it does not have to earn a market rate of return (avoiding losses is considered a success); it does not have to charge sales taxes on its products, or pay property taxes on the land, buildings, and equipment it owns, or pay vehicle registration fees, or pay parking tickets. And if it ever again earns profits, it does not have to pay income taxes.[14]

Because of these and other government-derived advantages, it is possible that a relatively inefficient Postal Service could earn positive net income in new areas to make up for losses (due to failure to control costs) on the products it now offers. This strategy would only work, however, if the organization can control costs and offer customers the products they want in the new areas and not suffer losses there. If Postal Service workers and managers gobble up the cost advantages with pay hikes, or inefficient production techniques squander the cost advantages, or customers spurn the Postal Service's new products because they prefer those of competitors, then expansion would worsen the agency's financial troubles.

In the past, despite its indirect government subsidies, the Postal Service has often lost money when it has introduced new products, due to a combination of high costs, inefficient use of its labor and capital resources, and difficulty in judging market demand. In one recent case the Postal Service announced it was discontinuing PosteCS, which had rung up costs of $7,000,000 while generating new revenues of only $8,000.[15] Obviously, a side venture that adds nearly $1,000 to costs for every $1 it adds to revenues will not help the Postal Service cover losses in its core business of non-urgent letter delivery. A General Accounting report from several years ago discusses many other (fortunately less extreme) cases.[16]

Notice that if the expansion strategy succeeds, with the result that an inefficient Postal Service uses its government-provided advantages to spread throughout the economy, it will displace more efficient private-sector firms along the way and reduce the U.S. economy's productivity. If the strategy fails, it will be adding new losses to the old ones. Neither result is a happy outcome. The real bottom line for the Postal Service is that expansion would most likely increase its losses, given its current cost structure. Improved cost management, not a bigger Postal Service, is the key to better financial results.

Allowing the Postal Service to carry out its proposed expansion would have additional drawbacks. It would increase the risk to customers within the postal monopoly of being forced to cross-subsidize money-losing ventures in competitive markets.[17] Taxpayers would be threatened because expansion would boost the odds that the Postal Service would eventually require a large taxpayer-funded bailout. Postal Service expansion would be unfair to private-sector businesses and their employees, who would have to compete with a government-sponsored rival exempt from many of the taxes they must pay and government regulations they have to obey. And from the point of view of the overall economy, as mentioned above, productivity would fall if Congress gave the Postal Service the green light to displace more efficient private-sector businesses in competitive markets.

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Pricing With Fewer Regulatory Controls

A key innovation in the 1970 legislation which created the Postal Service out of the Post Office Department was that Congress relinquished direct control of postal rate setting and placed the regulatory approval process in the hands of the Postal Rate Commission (PRC). Congress did not allow the Postal Service to determine its rates by itself because Congress feared the organization might abuse its considerable powers as a government-owned entity with a government-granted monopoly on non-urgent letter delivery. The PRC has authority to deny or scale back rate changes that the Postal Service requests, and frequently exercises that authority. The PRC may also restrain the Postal Service by providing somewhat more transparency regarding the Postal Service's operations by prodding the Postal Service during rate cases to disclose information about its various expenses that it would not otherwise release.

The Postal Service's Governors can override the PRC by a unanimous vote (although it has rarely done so). Nevertheless, from the start, the Postal Service has chafed under the regulatory restraints and pleaded for more "flexible" pricing. To be sure, some flexibility is appropriate, and already permitted under current law. For example, the PRC allows the Postal Service to offer discounts to customers who do work-sharing that saves the Postal Service money. These cost-based discounts, which mailers only accept on work that they can do at less cost than the Postal Service, help both sides financially. The PRC correctly calls them "a classic 'win-win' situation".[18] The Postal Service asserts that it would also be consistent with current law if in future rate cases the PRC allows rates to change in a series of small steps over several years. That suggestion merits investigation by the Postal Service and the PRC regarding details and practicality.

The Postal Service's objection, however, is to the regulatory structure itself. It wants to sharply reduce the PRC's role. The Postal Service says it "should have broad flexibility to set prices" provided it stays "within overall parameters managed by the PRC" and itself.[19] It latest plan calls on Congress to rewrite the law to reduce regulatory controls in this fashion, while letting the Postal Service keep all its existing powers.

This proposal has serious hazards. The PRC already "has growing concerns regarding the markup of First-Class Mail... [There has been] a shift in the institutional cost burden among the subclasses, with the monopoly class bearing a greater burden than historically found to be appropriate."[20] In plain language, first-class mail is a cash cow for the Postal Service. Because demand for it is relatively inelastic, the Postal Service would be tempted to increase first-class mail's price further, as a revenue raiser, if the PRC's oversight were downgraded.[21] The danger that the Postal Service would use its monopoly power to force first-class mail customers to cross-subsidize other products would be particularly great if Congress permitted the Postal Service to expand further in competitive markets.

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Consider another hazard. At present, the Postal Service must charge the same rate to different customers who receive identical services. The intent is to make sure the agency does not use its government-related powers to reward friends and punish enemies. The Postal Service's pricing proposal would change that. Under the proposal, the agency could provide the same level of service to two mailers but charge them different rates, depending on factors such as whether or not they agreed to do more business with the Postal Service (and, hence, less business with Postal Service rivals).

If the Postal Service were not part of the government and did not possess a statutory monopoly, it should be able to set whatever prices it chooses, subject to market discipline. But given the agency's powers, the reasons Congress had in 1970 for limiting the Postal Service's pricing discretion are just as valid today. Although the PRC should try to streamline the pricing regulations under existing law when that can be done without compromising regulatory oversight, the pricing controls should not be abandoned unless the Postal Service also abandons its government-based powers.

Will the Transformation Plan Be an Obstacle To Financial Improvement?

Government-owned enterprises throughout the world are virtually synonymous with red ink. One reason for high costs and low productivity is that the managers of government enterprises lack the market-based incentives and controls found in the private sector. For example, a government business can lose money year after year (as many do) and continue operating; a private-sector business with the same losses would soon go broke, and its labor and capital resources would be redeployed to more efficient firms. Another reason for financial difficulties is that for political reasons lawmakers often block key cost-cutting steps that a well-run business would undertake. Because government ownership and control are basic causes of poor performance, governments have found that privatization often achieves the largest cost reductions and biggest productivity increases.

The Postal Service's leaders, however, dismiss privatization as "inappropriate, or at least premature."[22] They describe their proposals as turning the Postal Service into a "Commercialized Government Enterprise" and insist their approach "carries the businesslike transition ... to the next level."[23] They do not recognize that government ownership and control are fundamental impediments to sound business practices.

If the Postal Service remains a government enterprise, controlling costs is an uphill struggle, but that is still where management needs to focus its energies. Unfortunately, the Postal Service's expansion and pricing proposals, besides being misguided in their own right, may draw attention away from the importance of better cost management. For instance, lawmakers might think from the plan that they can avoid the political pain of better cost controls while still doing good by approving the Postal Service's expansion and pricing recommendations. The reality is that only the cost-management proposal serves the public interest.

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Conclusion

The Postal Service claims its financial problems are due to a combination of factors: high costs, regulatory restrictions that limit its activities in competitive markets, and regulatory restrictions on its prices. The "Transformation Plan" it has sent to Congress calls for cost savings and fewer regulatory controls. The reality is that high costs — not regulatory limitations — are the basic cause of the Postal Service's long-standing financial problems. The Postal Service's recommendations for better cost management are on the right track. However, its recommendations for weaker regulatory controls would be bad public policy. The safeguards are needed to protect the public as long as the Postal Service remains a government agency with a large government-granted monopoly and many indirect government subsidies.

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Endnotes

1. United States Postal Service, *United States Postal Service Transformation Plan*, April 2002, accessed on the Internet at http://www.usps.com/strategicdirection/transform.htm.

2. *Transformation Plan*, p. iii.

3. Postal Rate Commission, *Postal Rate And Fee Changes, 1994: Opinion And Recommended Decision* (Washington, DC: Postal Rate Commission, 1994), p. II-31. The Postal Rate Commission is a federal regulatory agency, separate from the Postal Service, that approves or denies the Postal Service's rate requests after holding formal hearings. The Postal Service, however, can implement a rate that the PRC rejected, if the Postal Service's Governors unanimously vote for it.

4. See, for example, Marvin Runyon, "Address by Postmaster General Marvin Runyon to the National Press Club, Washington, DC, January 31, 1995, quoted in part in J. Gregory Sidak and Daniel F. Spulber, *Protecting Competition From The Postal Monopoly* (Washington, DC: AEI Press, 1996), p. 5.

5. United States Postal Service, *Annual Report*, various years.

6. United States Postal Service, *Annual Report, 2001*, pp. 48-49.

7. John E. Potter, "Remarks of Postmaster General John E. Potter at National Press Club," Washington, DC, April 5, 2002, accessed on the Internet at www.usps.com/strategicdirection/_txt/pmgnpcfinal.txt.

8. Barry T. Hirsch, Michael L. Wachter, and James W. Gillula, "Postal Service Compensation And The Comparability Standard," *Research in Labor Economics*, 1999, pp. 243-279, accessed on the Internet at www.trinity.edu/bhirsch/RLE_Postal%20Comp.pdf.

9. *Ibid.*

10. See *Transformation Plan*, especially Appendix E. The Postal Service's "baseline" forecast is that total mail volume will soon start declining due to electronic diversion. (See United States Postal Service, *Five-Year Strategic Plan, FY 2001-2005*, 2000, accessed on the Internet at www.usps.com/history/_pdf/fiveyear.pdf.) Because the Postal Service talks so much about below-expectation revenue growth, slow growth, declines in specific market segments, and the threat of electronic diversion, it may come as a surprise to many people that revenues and mail volume have been increasing up to now, with the exception of a few isolated years.

11. Marvin Runyon, "Remarks at the 1997 NAPUS National Convention," at Philadelphia, PA, August 25, 1997, accessed in 1998 on the Internet at www.usps.gov/speeches/97/082597a.htm.

12. *Transformation Plan*, p. 3.

13. *Transformation Plan*, p. 2.

14. 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.

15. Rick Brooks, "UPS Will Cease Document Delivery Via The Internet," *Wall Street Journal*, April 10, 2001, p. B4. As the article makes clear, e-commerce has also been a challenging area for private-sector companies, and many are reevaluating their plans in that sector, but at least they are not playing with taxpayers' money and the money of monopoly-market customers.

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

17. This danger and some of the other risks are examined in Michael Schuyler, "Transparency: Using Financial Openness At The Postal Service To Protect Consumers And Taxpayers," *IRET Congressional Advisory*, No. 125, March 27, 2002.

18. Postal Rate Commission, *PRC Opinion R2001-1*, March 22, 2002, p. 64, accessed on the Internet at www.prc.gov/news/2002/R2001-1/R2001-1.pdf. The PRC is quoting from an earlier opinion, *PRC Op. MC95-1*.

19. *Transformation Plan*, p. x.

20. PRC, *PRC Opinion R2001-1*, p. 49.

21. Perhaps this explains the puzzling suggestion in the Postal Service's plan that its financial objective be changed from breaking even — a goal it has been unable to meet in most years — to earning profits. (See *Transformation Plan*, pp. 66, 67, and B-3.) Maybe the Postal Service is thinking it can generate net income by charging first-class mail users much higher rates. (Or maybe it is looking at its expansion proposal and optimistically assuming that, contrary to many of its past experiences, it can earn big money on new products.)

22. *Transformation Plan*, p. 70.

23. *Transformation Plan*, p. viii.
