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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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THE POSTAL SERVICE: A MONOPOLY THAT LOSES MONEY

The Postal Service is running large and growing deficits. At the end of June, the price of a first class stamp will rise from 34 cents to 37 cents, an 8.8 percent increase, to restore fiscal balance. At the end of May, the members of the National Association of Letter Carriers approved a five year contract with the Postal Service that incudes a 7.1 percent real wage increase over the period — it comes on top of cost of living increases — with the first step increase of 1.8 percent retroactive to November 17, 2001.[1] Clearly, more postage rate increases are in store.

The *Postal Service Transformation Plan* recommends that the Postal Service be converted into a Commercial Government Enterprise and allowed to expand its product lines and operations to reduce its projected deficits.[2] Higher volume, it claims, would make it easier to cover its many areas of fixed costs. It seeks to offer additional products and services to "leverage" its franchise and increase utilization of its many retail outlets, processing operations, truck fleets, and route carriers. Before such changes are adopted, it would be wise to look at how the Postal Service is handling its current operations, and to see if expansion is likely to generate the financial benefits anticipated by the Postal Service. In particular, one might ask why the Postal Service is losing money in spite of its status as a government sanctioned tax-exempt monopoly, and what the proposed expansion would do to change the situation.

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Monopoly profits: Now you see 'em, now you don't!

Most people think of monopolies as powerful companies that earn large profits, or at least larger profits than firms in competitive industries. (See charts 1 and 2 in the Appendix.) Even with monopoly power, however, there is a profit maximizing price, above which volume will decline to such an extent that it will result in lower revenues and profits. Monopoly profits are finite.

Furthermore, not all monopoly situations lead to monopoly profits. There are two situations in which a monopoly can lose money. One is weak demand; the other is high costs. In both cases, costs exceed revenues. (See chart 3 in the Appendix.)

Suppose the monopoly is well managed and efficient, and that it obtains its inputs at the lowest possible cost in competitive factor markets, but the demand for its product is too weak to cover costs. The public simply does not value the product highly enough to pay for it.

Alternatively, suppose that the monopoly faces higher than normal costs. Perhaps the monopoly is

badly managed and is inefficient, or perhaps it faces, in turn, a monopoly provider of raw materials or labor inputs. In either case, its costs may be pushed above the levels that its customers are willing to pay, and the monopoly may find profits of any kind elusive. The Postal Service suffers from both problems.

The Postal Service has raised rates on many occasions over the years to fight deficits. Normally, each rate increase is followed by a few years of profitable operation (or at least lower deficits). However, over time, costs rise to eat away the financial improvement, and the Service finds itself back in difficulty.

The Postal Service would have us believe that the rising costs are due to required expansion of its delivery services to higher and higher cost areas as the country expands. However, the expansion of business and residential areas has not so greatly reduced the density of service as to account for the red ink.

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Whither wages?

A more likely culprit is labor costs, including workers' wage, retirement and medical compensation and bonuses paid to management. The Postal Service admits it has serious problems with its labor costs. The *Transformation Plan* states:

> Despite significant gains in efficiency and productivity though automation, Postal Service costs are rising faster than revenues. Most postal employees are covered by collective bargaining and are paid an average wage/benefit premium in excess of comparable private sector wages and benefits... In 2001, compensation and benefits accounted for 76 percent of total Postal Service expenses.[3]
>
> In an organization that remains overwhelmingly labor-intensive, compensation and labor policies are too critical to the performance and cost for the postal system to ignore in the near term... Labor agreements are, by far, the largest single element of the Postal Service's costs and therefore the primary determinant of prices and the key factor in the Postal Service's overall financial viability.[4]

Making the cost issue especially punishing, rapid wage increases have teamed up with slow productivity growth. As a result, unit labor costs have increased substantially faster at the Postal Service than for the economy as a whole. Between 1987 and 2000, unit labor costs in the non-farm business sector rose 31 percent. Unit labor costs at the Postal Service rose 45 percent, about half again as much.[5]

The future is apt to be no better. The new compensation agreement reached by the Postal Service and the National Association of Letter Carriers will boost letter carriers' real wages by 7.1 percent over the contract period. This just exceeds the increase in output per hour for the Postal Service over the last five years[6], so even if that labor productivity gain is repeated, real wage increases of this magnitude will eat up all of the productivity improvement, leaving none to reduce the deficit.

Postal wages are set by collective bargaining with an arbitration panel assigned to work out differences without strikes. But like most federal, state or local government entities, the Postal Service has had difficulty keeping labor and other costs in line with private sector equivalents. The problem is not confined to the Postal Service. Consider the cost pressure faced by officials overseeing transit, police, fire, municipal utility, and other government

service operations, whether at the federal, state, or local level.

No constraint, no restraint.

In a competitive industry with competitive factor markets, there are many natural checks on costs. First, labor and materials inputs are readily available at competitive market prices. Second, no single firm can push up product prices, or it will quickly lose customers to other firms. The demand for its product is extremely elastic because of the ready availability of near-perfect substitutes from other providers.

But what if the labor market is not competitive and atomistic? If a competitive firm faces a strong company union, it can still hold the line on costs by pointing out that it cannot raise its sales prices in the face of competition. Excessive wage demands that would force a price hike would cost the firm a lot of business to its competitors, and cost its employees their jobs.

But what if the union is industry wide, as has been the case on occasion in the auto industry? The union could force the same labor contract settlement on all firms in the industry, in effect eliminating competition from workers of other companies. If so, the workers, via their companies, are constrained only by the industry demand curve. Industry-wide demand is far less elastic than the demand curve faced by any one company within the industry; not buying the product means consumers are shifting to a different product which is a less perfect substitute for the original purchase than is buying a similar item from a different supplier. For example, people will more readily switch from one make of car to another than from driving to using public transportation, bicycling, or walking. Still, higher prices will cost some sales and some jobs in the industry. Also, there is the possibility of competition from imports or new start-up companies not subject to the union contract. Recall the demise of Studebaker and AMC and the advent of Volkswagen and Toyota to the U.S. market in the 1960s and 1970s.

Pending rate increases are ... projected to raise revenue... Unfortunately, in the absence of new and effective cost containment, there is nothing new in the way the Postal Service operates to prevent the additional revenue from being absorbed by higher payments to labor and management, and any return to profitability will be short-lived, just as in the past.

When the company is a government-mandated monopoly, and the unions are automatically industry wide, the labor force has maximum pricing power. If, in addition, the company is a government enterprise in which management is not responsible to angry shareholders wondering where their profits have gone, labor and management may share a common interest in raising compensation for all concerned and passing on the added costs to the public. The only constraint on the pricing power is if customers are willing to cut back on the use of the monopolized services, substituting other goods or services instead, or if they raise a sufficient political protest to force politicians to curb the price increases.[7] Governments that have foresworn this bilateral monopoly by contracting out for services with private firms have generally saved a lot of money for their citizens.

From the old days to recent times, the substitutes for the mail available to consumers were telegrams, telephone calls, and faxes for letters; and newspaper, radio, and TV ads for mailed fliers. Long distance phone calls were very expensive several decades ago, but have gotten much cheaper over the years. The art of letter writing has faded; few letters these days are person to person, and much of that small volume is greeting cards. However, business mailings, consumer billing, and bill paying have grown, and Postal Service volume has risen (although more slowly in recent years) in spite of the alternatives.

Now the computer revolution provides additional substitutes. The Postal Service is clearly worried that e-mail, on-line bill paying, and on-line advertising will cut into its first class and

advertising mail volume, and reduce its revenues. (The phone companies are also concerned about e-mail and computer voice messaging.)

But there is nothing yet to suggest that these new substitutes have changed the situation. Recent rate increases have shown that an increase in postage rates will still bring in additional revenue, because volume will not decline by enough to offset the rate hike. Pending rate increases are likewise projected to raise revenue. Radical reform is not justified by fundamental changes in the responsiveness of revenues to rate hikes. Unfortunately, in the absence of new and effective cost containment, there is nothing new in the way the Postal Service operates to prevent the additional revenue from being absorbed by higher payments to labor and management, and any return to profitability will be short-lived, just as in the past.

It is not likely that converting the Postal Service to a Commercial Government Enterprise will bring the market discipline needed to bring its costs under control. Real privatization might do the trick. The alternative may be a return to a more carefully monitored and regulated government service focusing on its narrow mandate to deliver the mail.

No substitute for minding one's own business.

If competition from e-mail and other computer services turns out to be as bruising as the Postal Service fears, then there is no substitute for holding down costs and boosting productivity. If the competition proves to be less serious, there is still no substitute for holding down costs, because the rate hike will otherwise be dissipated in more generous compensation. As for the Postal Service's requests to expand into new product lines in competition with the private sector, there are two likely outcomes. One is that the new lines will be run more efficiently and more competitively than the old lines, but any profits transferred to the monopoly and other existing segments of the Postal Service will just be absorbed in higher costs there, as usual. The other outcome is that the Postal Service will carry over its money losing ways to the new areas, and there will be no profit in those business lines to help cover the deficits in existing postal activities. Moreover, to make up its losses in the new markets, the Postal Service will have to raise rates within its monopoly more than otherwise or seek more help from taxpayers.

The Postal Service is not the only enterprise seeking to "leverage" its many retail outlets by offering new kinds of products and services alongside its traditional lines. McDonald's has recently indicated an interest in finding new things to sell and services to offer at its thousands of restaurants. Some might be food related, others not. One might well ask, will it be easier to sell stamps at McDonald's, or to sell hamburgers at post offices? The Postal Service may face stiff competition in any new ventures it undertakes. Expansion will be no substitute for cost containment and improved efficiency in its current lines of business.

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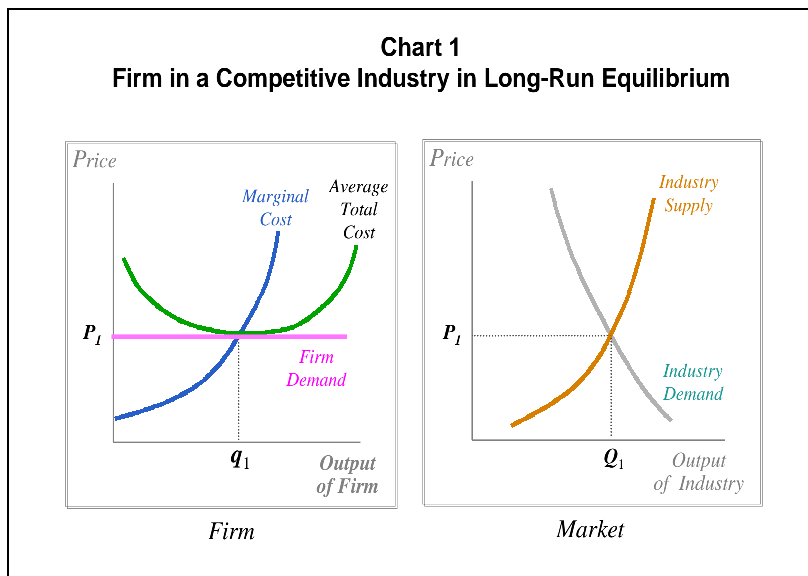
Stephen J. Entin
President and Executive Director

Appendix

This Appendix illustrates several of the cases described earlier using the traditional Supply and Demand graphs of economics.

Chart 1. A firm in a competitive industry must take the price set by the market (P). It faces infinitely elastic demand at the market price (the horizontal line). It expands to the point where the price just covers the rising marginal cost of adding one more unit of output, and will adjust firm size to bring average total cost to a minimum at that point. Cost includes a normal return on invesment, which will just be sufficient to attract the capital to the industry. Above normal "economic profit" is zero.



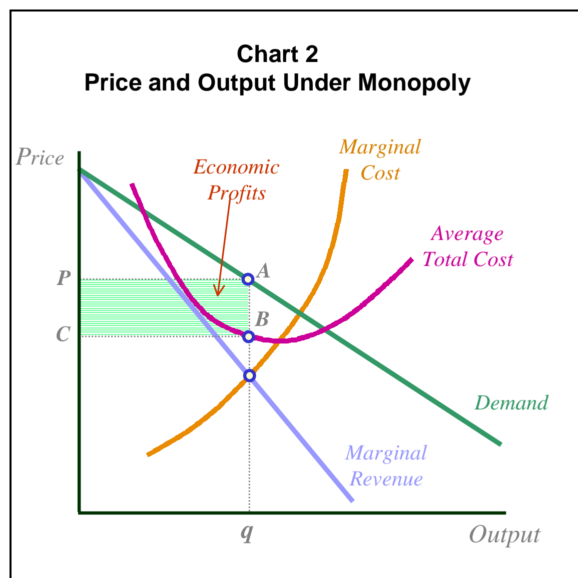


Chart 2. A monopoly finds that altering output changes the market price. It will maximize its income by producing where its marginal cost equals marginal revenue (taking note that selling another unit will reduce the price of previous units and trim the net revenue received from the added sale). This output (q) is less than the output where marginal cost equals price. The price (P) set by the demand curve at the chosen quantity will normally exceed average total cost (C), and the firm will earn an "economic profit" in excess of normal returns of ABCP (the "monopoly profit").

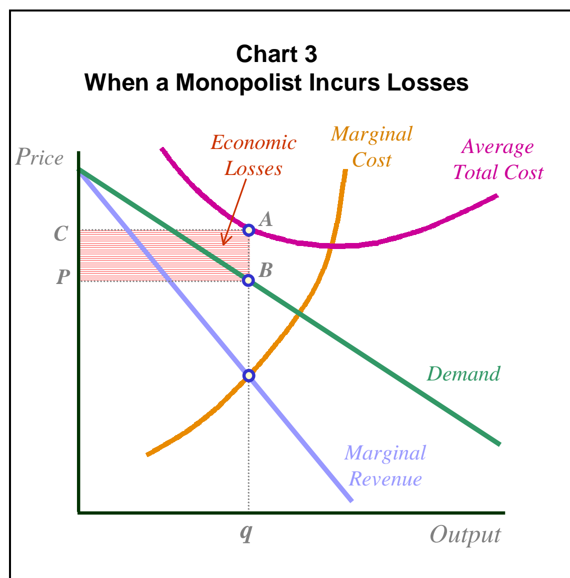


Chart 3. Even a monopoly will lose money (ABPC) at its best level of production if its costs exceed the prices people are willing to pay for the product.

Endnotes

1. See the announcement of the approval of the agreement by the letter carriers on the NALC web site at http://www.nalc.org/news/bargain/index.html.

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

3. *Transformation Plan*, p. 4.

4. *Transformation Plan*, p. 52.

5. These productivity growth rates have been calculated by the author from U.S. Bureau of Labor Statistics data accessed on the Internet on 05-30-02 from http://www.bls.gov/lpc/home.htm and at ftp://ftp.bls.gov/pub/special.requests/opt/dipts/ULC3Din.txt.

6. See U.S. Bureau of Labor Statistics data accessed on the Internet on 05-30-02 at ftp://ftp.bls.gov/pub/special.requests/opt/dipts/oaeh3din.txt.

7. Congress used to set postage rates and rule on wage agreements in the days of the old Post Office. It faced anger from the voters if it approved postage rate hikes, and anger from the postal workers if it did not. To avoid such responsibilities and confrontations, Congress delegated rate setting and wage setting to the Postal Rate Commission, the Postal Service, and the wage arbitration panel in the Postal Reorganization Act of 1970.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.