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HOW TO BRING POSTAL COMPENSATION INTO LINE WITH THE PRIVATE SECTOR

Executive Summary

- Numerous economic studies have concluded that employees of the Postal Service receive much higher wages and benefits — up to 30% or 40% higher — than do comparable workers in the private sector of the U.S. economy. Many neutral labor arbitrators have reached similar conclusions.

- The "postal pay premium" imposes an enormous financial burden on the labor-intensive Postal Service. Merely reducing the compensation premium from 30% to 10% would have saved the Postal Service $8.1 billion in 2001 alone, enough to have avoided the recent postage increase. The postal pay premium is also contrary to clear statements in federal law that postal pay should be comparable to private sector pay.

- If postal wages and benefits were comparable to those in the private sector, the cost savings would allow the Postal Service to operate in the black *and* cut postal rates.

- There are many workable methods for bringing postal compensation into closer alignment with private sector wages and benefits. Some of the options are:

  - Increase postal compensation at the rate of inflation until the postal pay premium is reduced or eliminated.
  - Increase postal pay more slowly than increases in an index of private sector labor costs to gradually reduce the postal pay premium.
  - Restrain postal wages when the postal worker quit rate is very low or the number of qualified people seeking postal jobs is very high.
  - Vary postal wages by geographic region.
  - Instruct labor arbitrators, who often determine postal compensation in binding arbitration proceedings, to give more weight in their awards to pay comparability.
  - Expand the use of worksharing discounts where possible.
  - Increase the use of part-time and temporary employees who would receive market or above-market compensation but less of a pay premium than full-time career employees.
  - Privatize the Postal Service and remove its monopoly and other special privileges so that the same market forces which determine compensation for other workers can operate at the Postal Service.

- Because the Postal Service's financial problems are mainly due to bloated costs and most of its costs are for labor, reducing or eliminating the postal pay premium should be a central element of Postal Service reform.

- Although it may be politically tempting to try ducking the issue, the U.S. Postal Service will almost certainly remain financially sick unless the problem of its above-market wages and benefits is tackled.

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HOW TO BRING POSTAL COMPENSATION INTO LINE WITH THE PRIVATE SECTOR

As an employer, the Postal Service shall achieve and maintain compensation for its officers and employees comparable to the rates and types of compensation paid in the private sector of the economy of the United States. — The Postal Reorganization Act of 1970 (39 U.S.C. 101(c))

It shall be the policy of the Postal Service to maintain compensation and benefits for all officers and employees on a standard of comparability to the compensation and benefits paid for comparable levels of work in the private sector of the economy. — The Postal Reorganization Act of 1970 (39 U.S.C. 1003(a))

Introduction. Federal law declares that Postal Service employees should be paid cash wages and fringe benefits comparable to those received by workers in the private sector. Nevertheless, many economic studies have concluded that postal workers are paid much more than comparable workers in the private sector. A previous *IRET Congressional Advisory* reviewed these studies. (Michael Schuyler, "The Postal Wage Premium: No Wonder The Postal Service Loses Money," *IRET Congressional Advisory*, No. 131, July 24, 2002.)

The amount by which the pay of postal workers exceeds the pay of comparable workers in the private sector is known as the postal wage premium. In one recent study, economists Michael Wachter, Barry Hirsch, and James Gillula estimate that bargaining unit postal employees enjoy "a 23.7% wage advantage ... relative to private sector non-postal workers with similar characteristics... [and that] the wage premium calculated for *all* postal workers (78.5% coded union and the remainder nonunion) is ... 20.0%."[1] Their estimate of the wage premium for bargaining unit postal employees jumps to 36.2% when they use further information to better adjust for "job skill and working conditions".[2] And their estimate of the total compensation premium for bargaining unit postal employees climbs another 8 percentage points, to well above 40%, when they add in the Postal Service's generous fringe benefits.[3]

Because the Postal Service is so labor intensive — over three fourths of its costs are for labor[4] — its above-market wages and benefits have a huge negative effect on its bottom line. Suppose the Postal Service pays its employees 30% more than comparable workers in the private sector receive.[5] Merely reducing the pay premium from 30% to 10% would have saved the Postal Service $8.1 billion in 2001 alone.[6] That saving would have let the Postal Service break even with a first-class postage rate of 31¢, instead of 34¢.[7] Even if the Postal Service now needs 3¢ more to cover higher costs over the next few years, that would only have brought the first-class stamp rate to 34¢; the actual rate hike on June 30, 2002 from 34¢ to 37¢ would have been unnecessary. Although many Postal Service reforms are desirable, simply bringing postal wages more closely into line with private sector wages dwarfs most of them in terms of the positive impact it would have on the troubled agency's finances.

This *Advisory* discusses a number of options for better aligning postal pay with private sector pay, that is, reducing the postal compensation premium. It should be stressed that the aim is not to pay postal workers any less than they would receive for comparable work in the private sector. The aim is only to slim down the extra compensation they receive above that of similar private sector workers. It should also be noted that the postal pay premium discussed here is an average. Not all postal workers are equally well paid compared to what they could earn in the private sector. The postal pay premium tends to be smallest for employees in high-wage localities or with specialized in-demand skills. Indeed, out of a workforce of approximately 900,000 people performing a wide variety of tasks, some are undoubtedly receiving pay in line with their skills and positions and should not experience any pay reduction relative to private sector workers. An important task is to determine where compensation is particularly high and where it is not, and redress those imbalances within the Postal Service.

Increase postal compensation at the rate of inflation until the postal pay premium is reduced or eliminated. This is a gradual solution. Sustained pay growth in the private sector is generally the sum of inflation and productivity gains. Suppose the growth of postal compensation were held to the rate of inflation (i.e., no real pay growth). By increasing postal pay at a slightly slower rate than private sector pay, this procedure would slowly narrow the differential between postal and private sector compensation, while insuring that postal pay never falls in real terms.

Increase postal pay more slowly than increases in an index of private sector labor costs until the postal pay premium is reduced or eliminated. An idea that has interested the Postal Service is to tie postal pay increases to an index of private sector pay, less an adjustment meant to gradually reduce the postal wage premium. Economists Barry Hirsch, Michael Wachter, and James Gillula write, "A goal of the Postal Service has been to lock-in moderate wage restraint through an explicit linkage of postal compensation to changes in the Employment Cost Index (a fixed-weight index of private sector compensation), minus an adjustment factor to gradually reduce the postal premium."[8] This method would be incremental (in that postal compensation would continue rising), but over time it would significantly narrow the gap between postal compensation and the private sector compensation of similar workers.[9]

Restrain or freeze postal wages when the postal worker quit rate is very low. Douglas Adie, one of the first economists to estimate the size of the postal wage premium, suggested that the Postal Service not be allowed to hike its rates to finance wage increases when the percentage of postal workers quitting their jobs is much lower than the quit rate in the private sector.[10] More directly, in a slight variation on Adie's proposal, the Postal Service might be prohibited from increasing wages when the postal quit rate drops below a specified, low number. The logic is that a low quit rate indicates there is a substantial postal wage premium and that the Postal Service is paying more than needed to attract and retain qualified employees. This approach has the advantage of using the market signals of postal workers themselves to determine their compensation.

Restrain or freeze postal pay when the pool of qualified job applicants is very large. Alternatively, postal pay increases might be denied when the number of qualified applicants seeking each postal job is very large compared to the applicant-to-job ratio in the private sector. This test is similar to the previous one, except that it adjusts postal pay using the market signals generated by postal job applicants. It should be noted that both tests avoid the harshness of pay cuts. They would do their work by postponing postal pay increases, when postal compensation is seriously out of line with private sector compensation.

A refinement on this technique would be separating postal workers based on the jobs they perform, and looking at quit rates for the various subgroups. While the postal quit rate is very low on average, the Postal Service reportedly has problems retaining workers in some skilled specialties. If the average quit rate is low but some specialties have high quit rates, the market is signaling that there is a relative pay imbalance within the Postal Service. To help correct that imbalance and better enable the agency to keep the skilled workers it needs, it would make sense to freeze pay in categories where the quit rate is very low, but not do so in specialties where it is higher.

Vary postal pay by geographic region. Although the federal government has long varied pay by region for many of its other jobs, postal pay is uniform nationwide. Adie, among others, has suggested that the Postal Service begin varying its pay by region, paying less in low-wage areas and more in areas where prevailing wages are higher.[11] Introducing geographic differentials would allow the Postal Service to pay enough in high-wage areas to attract and retain qualified employees without forcing it to overpay in low-wage areas. Instead of adjusting postal pay to reflect regional differences in wages, an alternative would be to look at cost-of-living indexes and vary postal pay based on cost-of-living differences among areas. (Again, this technique could better reflect market signals by distinguishing among various jobs at the Postal Service, and not applying the freeze in areas where the Postal Service has difficulty attracting qualified applicants.)

Instruct labor arbitrators to accord more weight to pay comparability. Postal workers are not permitted to strike. When the Postal Service and one of its unions fail to reach a collective bargaining agreement, the dispute goes to binding arbitration. The postal pay premium frequently arises as an issue in these proceedings, and many arbitrators have concluded that a substantial premium exists, based on the Postal Service's huge pool of job applicants, low quit rate, generous fringe benefits, and exceptional job security, as well as human capital models indicating that postal workers receive much richer compensation packages than comparable workers in the private sector. Among the arbitrators persuaded by the evidence, starting with Clark Kerr in 1984, are Arnold Zack in 1985, Martin Volz in 1985, Richard Mittenthal in 1991, Rolf Valtin in 1993, Arthur Stark in 1995, David Vaughn in 1996, Stephen Goldberg in 2001, and John Wells in 2002.[12]

In response to the "discrepancies" between postal and private sector compensation, arbitrator Kerr in 1984 introduced a policy of "moderate restraint". His arbitration award called for "a slowing of wage increases, as against the private sector, by 1% a year or for 3% in total over the life of this contract."[13] The main effect in the near term was to prevent the postal wage premium from growing wider. Kerr recognized that his small adjustment "does not dispose of the problem. Moderate restraint may also be necessary in [agreements and awards in] future years to approximate the guidelines of comparability as established by Congress."[14]

Because many subsequent arbitrators did follow Kerr's lead, economists Wachter, Hirsch, and Gillula estimate that the postal compensation premium was smaller in 1998 than it had been 20 years earlier, although it remains very large (see page 2).[15] D. Richard Froelke, former manager of collective bargaining at the Postal Service, credits the restraint with being largely responsible for several years of Postal Service profitability in the mid and late 1990s.[16] Unfortunately, those few years of profits appear to have diminished arbitrators' restraint. The Postal Service observes in its latest *Annual Report*, "Our labor costs have grown very rapidly in recent years ... partly as a result of arbitration decisions that awarded substantial pay increases to some craft employees."[17] The Postal Service may also have contributed to its renewed financial troubles with some generous voluntary labor settlements. A case in point is the five-year contract recently negotiated by the Postal Service and the National Association of Letter Carriers. It includes cost of living increases and a 7.1% real wage hike on top of that, with the first step increase of 1.8 percent retroactive to November 17, 2001.[18]

If labor contract impasses at the Postal Service continue to be resolved through binding arbitration, it would be worthwhile to remind arbitrators of the importance of the comparability standard in current law. This could be done with statutory guidance that instructs arbitrators to explicitly consider wage and benefit comparability in their decisions and discuss whether their awards move toward or away from that objective. Although arbitrators have considerable discretion, they would probably place more emphasis on wage and benefit comparability following this change, with the result that their awards would be less likely to widen the postal pay premium and more likely to narrow it.

Allow PRC to disapprove arbitration awards it deems excessive. Under current law the Postal Rate Commission (PRC) has responsibility for setting postal rates that protect customers while allowing the Postal Service to cover costs. (The PRC is the independent federal agency that regulates postal rates.) But while the PRC has authority to set aside or modify rate requests from the Postal Service that it deems unjustified, it has no such authority with respect to the awards of labor arbitrators. Because the Postal Service's major cost is labor, the effect is that the PRC's ability to set postal rates is often subservient to the decisions of labor arbitrators. When a generous arbitration award significantly increases Postal Service costs, the PRC has little choice but to grant a postal rate hike. The PRC's ability to protect postal customers would be enhanced if it were given statutory authority to set aside or modify arbitration awards calling for pay increases that it judged excessive. Over time, the check this would place on the power of arbitrators' would reduce the postal pay premium from what it would otherwise be.

Worksharing Discounts. Governments at all levels have often achieved spectacular cost savings by outsourcing work to more efficient private sector businesses. This is one of the few financial bright spots for the Postal Service; it has pursued this option vigorously, often through worksharing discounts. The idea behind a worksharing discount is as follows. The Postal Service estimates the cost of a task and how much it could save if it did not have to perform the task. It submits detailed evidence of this to the PRC within the ratemaking process, and suggests that mailers who do the task themselves before submitting mail for delivery receive a discount equal to a portion of the avoided cost. (Going through the ratemaking process provides transparency and verifies that the purported saving are reasonably estimated.) If the PRC is satisfied with the evidence, it approves the discount. Mailers accept discounts for tasks such as presorting when the discount is larger than what it costs them to do the work. Provided that the avoided costs are estimated accurately, worksharing saves money for both the Postal Service and mailers.[19] In 1999, mailers did some worksharing on nearly half of first-class mail and most third-class (now called Standard A) mail.[20] By shifting some work from the government-owned Postal Service to private sector businesses, worksharing is, in effect, a limited form of privatization.

According to Robert Cohen, William Ferguson, John Waller, and Spyros Xenakis, who are PRC economists, the Postal Service would have had to hire 187,000 extra workers in 1999 if not for worksharing, which would have increased its labor force from about 900,000 to about 1.1 million and raised its labor costs that year by approximately $8 billion.[21] In other words, while the postal pay premium is a huge financial burden now, it would be an even worse problem without worksharing because the Postal Service would then be paying above-market compensation to about 20% more workers. If further mutually beneficial worksharing opportunities can be identified, they should be pursued. (To be clear on an important point, this does not require firing any current postal workers. With proper planning, the workforce adjustments can be accomplished through attrition.)

Other contracting out possibilities that reduce the number of relatively expensive postal workers should also be considered. For example, Charles Guy, former Director of the Postal Service's Office of Economics, Strategic Planning, suggests looking for contracting-out savings in the final leg of the mailing process, as well as the initial stages. He writes, "[L]ocal communities might [be allowed to] choose to employ their own delivery forces to deliver mail from a USPS drop-off point."[22] One means of implementing this idea would be to have the PRC determine how much the Postal Service could save if it delivered mail to a central drop-off point within a locality, instead of having to carry it all the way to individual home and business destinations. The locality would then be offered a lesser amount if it performed this service. For localities with costs sufficiently below those of the Postal Service, this work-sharing arrangement would financially benefit both sides.

Increased use of part-time and temporary employees receiving less of a pay premium than full-time career employees. This is another avenue that the Postal Service has taken. When the Postal Service hires more part-time and temporary workers at competitive pay, it needs to hire fewer other workers at above-market pay. It should be stressed that this approach does not harm part-time and temporary workers. If the Postal Service offers pay packages for part-time and temporary employment inferior to what is available in the private sector, people looking for work will reject those postal jobs in favor of private sector employment. To attract and retain qualified part-time and temporary workers, the Postal Service must offer them competitive pay. Unfortunately, the Postal Service's ability to use this approach has been limited by arbitration decisions. Statutory language that expanded the agency's ability to hire more part-time and temporary employees at compensation matching that in the private sector would significantly decrease its labor costs.

Privatization. A much more fundamental reform than those discussed above would be to privatize the Postal Service and remove its monopoly and other special privileges. Although difficult to achieve, this would be the surest way to bring postal wages and benefits into line with those in the private sector. Full privatization would let the market decide what pay is appropriate, rather than having politicians, arbitrators, and economists argue about it. The owners of a privatized Postal Service would have an incentive not to pay more than market wages because that would reduce their profits, especially since labor comprises about three quarters of production costs. The managers of the current, government-owned Postal Service lack the cost-control incentive provided by the profit motive. On the other hand, market forces would prod the owners of a privatized Postal Service not to pay less than market wages, because otherwise too many good workers would leave for better wages at other companies.

Postal workers naturally want the best wages they can obtain, but at a privatized Postal Service without special government favors, market forces would place a damper on excessive wage demands. One consideration is that if some workers demand above-market wages, private sector employers can find other workers who are glad to accept the jobs at pay market wages. A second consideration if that if workers succeed in driving a business's wages above market levels, the company will experience a cost disadvantage compared to other firms and tend to suffer declines in sales and employment over time.

For market discipline to work properly, it is crucial that the privatized company not retain its monopoly. Otherwise, the company could charge monopoly prices to consumers, and the company's owners and workers would divide the monopoly booty in the forms of above-market profits and above-market wages.

There are additional, important advantages to ending the postal monopoly and the Postal Service's other government-based advantages. Privatization and the end of the postal monopoly would harness market forces to spur productivity, improve customer service, and expand consumer choice. Although the concern is often voiced that privatization would lead to service cutbacks or price increases in remote areas, Congress could retain below-cost mail service wherever it thinks that is appropriate by means of explicit government subsidies. Also, given the free market's superior inventiveness and responsiveness compared to a government-run enterprise, it is likely that in many important respects rural service would actually improve with privatization.

Conclusion. Economists and government officials should defer to markets where possible in setting workers' compensation. Markets are much better at discovering and weighing the relative skills, energy, and other characteristics of different workers and the demands made by their jobs. At the Postal Service, however, a hands-off approach is not possible because the government is already heavily intervening. Trying to estimate postal pay comparability and establishing mechanisms for moving towards that objective is a multi-billion dollar issue, with a massive impact on the Postal Service's finances.

There is extensive evidence that postal workers receive much higher wages and benefits than comparable private sector workers. This postal pay premium adds billions of dollars yearly to the federal agency's costs. It is the difference between a Postal Service that loses money and an organization that could operate in the black while charging lower rates than it needs today.

Because above-market wages are one of the central reasons for the Postal Service's financial distress, any plan that hopes to put the agency on a sound financial footing will be at a serious disadvantage unless it makes eliminating or at least narrowing the postal pay premium one of its central elements. This paper has described a wide range of techniques that could be used to decrease or eliminate the postal pay premium. Among the many workable options are privatizing the Postal Service, keeping the organization within the government but using market signals to better align its compensation with that in the private sector, statutory guidance to arbitrators, and increased use of part-time and temporary workers who are paid market wages.

Action in this area would require Congressional legislation. Although the political temptation to blink is strong, those who genuinely want a financially healthy Postal Service should understand that the organization will almost certainly remain financially sick unless the problem of its above-market wages and benefits is tackled.

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Endnotes

1. Michael L. Wachter, Barry T. Hirsch, and James W. Gillula, "Difficulties Of Regulation When Wage Costs Are The Major Cost," in Michael A. Crew and Paul Kleindorfer, eds., *Future Directions In Postal Reform* (Boston: Kluwer Academic Publishers, 2001).

2. *Ibid.*

3. *Ibid.*

4. United States Postal Service, *United States Postal Service Transformation Plan*, April 2002, p. 4, accessed on the Internet at http://www.usps.com/strategicdirection/transform.htm.

5. The assumption that postal wages and benefits are 130% of the compensation needed for comparability with the private sector is a plausible estimate, maybe even a little on the low side, based on the empirical evidence. (See Michael Schuyler, "The Postal Wage Premium: No Wonder The Postal Service Loses Money," *op. cit.*)

6. The Postal Service reported $52.954 billion of total labor costs in 2001. (U.S. Postal Service, *Postal Service Annual Report, 2001*, p. 23.) This amount is multiplied by 1.10/1.30 to find what labor costs would have been if the postal compensation premium had been reduced to 10%.

7. It is assumed the cost savings are used to close the Postal Service's 2001 deficit of $1.7 billion and finance an across-the-board cut in postal rates.

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.

9. For example, if the employment cost index for private sector compensation rises by 4% and the adjustment factor is 1%, postal workers would receive a 3% increase. Using these numbers and assuming the postal pay premium is initially 30%, the premium would be narrowed to 19% after 10 years and to 8% after 20 years.

10. Douglas K. Adie, *An Evaluation Of Postal Wage Rates* (Washington, DC: American Enterprise Institute, 1977), esp. pp. 108-110.

11. *Ibid.*, pp. 103-106.

12. Arbitration boards consist of an arbitrator selected by the Postal Service, another selected by the union, and a third ("neutral") arbitrator who serves as chair and effectively makes the decision. The arbitrators mentioned in the text are the neutral arbitrators.

13. Clark Kerr Arbitration Award (1984), cited in D. Richard Froelke, "Labor Market Outcomes Of Postal Reorganization," in Edward L. Hudgins, ed., *Mail @ The Millennium: Will The Postal Service Go Private?* (Washington, DC: Cato Institute, 2000), pp. 75-101, quote on p. 97.

14. *Ibid.*

15. Wachter, Hirsch, and Gillula, *op. cit.*

16. Froelke, *op. cit.*

17. U.S. Postal Service, *Postal Service Annual Report, 2001, op. cit.*, p. 18.

18. See the description of the agreement at http://www.nalc.org/news/bargain/index.html.

19. Postal unions often complain that worksharing discounts are money-losing giveaways. William Burrus, President of the American Postal Workers Union, goes so far as to brand them the "real cause of the Postal Service's financial problems." (APWU NewService, "GAO Begins Investigation of Postage Discounts," June 21, 2002, accessed on the Internet at http://www.apwu.org/nsb/2002/nsb1102.htm.) While the independent PRC has consistently found that such union accusations are unjustified, it is true that proposed worksharing discounts must always be examined carefully to be sure they do not exceed avoided costs.

20. Robert H. Cohen, William W. Ferguson, John D. Waller, and Spyros S. Xenakis, "The Impact Of Using Worksharing To Liberalize A Postal Market," white paper presented at a fWissenschaftliches Institut für Kommunikationsdienste GmbH (WIK), 6th Köenigswinter Seminar on Postal Economics, "Liberalization of Postal Markets," February 19-21, 2001, accessed on the Internet at http://www.postinsight.pb.com/go.cfm?file=WIK2001WinterSeminar%2Epdf.

21. *Ibid.*

22. Charles Guy, "Universal Postal Service: Without Competition, The Tail Wags The Dog," *Issue Brief*, Lexington Institute, June 27, 2002, accessed on the Internet at www.lexingtoninstitute.org/postal/universal.htm.
