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## **EMPIRE BUILDING AT THE POSTAL SERVICE**

### **EXECUTIVE SUMMARY**

The U.S. Postal Service is a huge organization that has suffered financial problems through most of its history. It is part of the federal government and enjoys an array of governmental powers. Despite its present size, Postal Service officials claim that the agency needs to grow bigger by expanding in markets now served primarily by private-sector producers if its finances are not to deteriorate further. The Deputy Postmaster General recently reiterated this, asserting, "The restriction that the Postal Service not be allowed to compete in areas where the private sector either already offers products and services, or could offer them, should not exist." Expansion attempts at the agency and its predecessor, the Postal Office Department, have a long history. The Post Office Department, for instance, sought unsuccessfully for many years to take control of the nation's telephone and telegraph services.

Several rationales are frequently offered for why expansion would supposedly help the Postal Service: that the already enormous government agency can realize untapped economies of scale and scope by growing still bigger; that it can easily make money in competitive markets to offset losses in its core market despite its long history of losing money; that its core market is shrinking and it can only avoid financial disaster by adding volume in other markets; and that as the number of homes and businesses increases, it needs revenues from expansion in other markets to cover the costs of expansion in its core market. Careful examination finds that all these claims are wanting. The reality is that Postal Service expansion into what are now mainly private-sector markets poses dangers for consumers within the postal monopoly, taxpayers, private-sector businesses and their workers, the overall economy, and even the Postal Service's own bottom line.

It would be good public policy to confine the Postal Service to its core monopoly market of non-urgent letter delivery. The key to a financially healthier Postal Service is better control of its costs, not expansion. Current laws should not be changed nor regulations loosened to let the Postal Service expand in competitive-product markets.

## EMPIRE BUILDING AT THE POSTAL SERVICE\*

The Postal Reorganization Act of 1970 converted the old Post Office Department into the U.S. Postal Service (USPS). Although the aim of the reorganization was to place mail delivery on a more business-like footing, the activity was kept within the federal government. The U.S. Postal Service is a wholly-government owned enterprise, officially located within the federal government's executive branch.

At the core of the U.S. Postal Service lies a vast monopoly bestowed on the organization by the federal government. Subject to certain exceptions, laws known as the private express statutes make it a criminal violation of federal law for anyone besides the U.S. Postal Service to deliver the equivalent of a first-class or standard (formerly third-class) letter, regardless of whether the private carrier could provide superior service or a lower price.<sup>1</sup> Beyond that, federal legislation passed in 1934 awards the Postal Service a monopoly on the use of people's home and business mailboxes. In return, the Postal Service accepts and delivers first-class mail throughout the nation at a single price, regardless of whether the letter goes to the next block or across the country. Postal revenues just from its protected core market of first-class and standard mail exceeded sales at McDonald's, Oracle, Apple Computer, Southwest Airlines, Charles Schwab, Hershey Foods, H&R Bloch, and Amazon.Com *combined* in 2002.<sup>2</sup>

Beyond its monopoly core, the Postal Service also operates in what may be called competitive markets—markets where it faces private-sector businesses offering similar products. With competitive-market products, it has generally been private-sector businesses — not the Postal Service — who either first offered the products or first understood how to make the products into commercial successes. The Postal Service, nevertheless, has persistently sought to expand in competitive markets. Indeed, many in the Postal Service claim that the government-owned entity *must* grow in competitive markets if it is to remain viable in its monopoly markets, and some outside of the Postal Service agree with that assessment.

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\* The material in this paper draws heavily on two earlier studies: Michael A. Schuyler, *Wrong Delivery: The Postal Service In Competitive Markets* (Washington, DC: Institute For Research On The Economics Of Taxation, 1998); and Michael A. Schuyler, "The Postal Service's Market Grab," in Edward L. Hudgins, ed., *Mail @ The Millennium: Will The Postal Service Go Private?* (Washington, DC: Cato Institute, 2000), pp. 25-43.

<sup>1</sup> For a detailed explanation of the private express statutes and their implications, see J. Gregory Sidak and Daniel F. Spulber, *Protecting Competition from the Postal Monopoly* (Washington, DC: The AEI Press, 1996), Chapter 2.

<sup>2</sup> See U.S. Postal Service, *U.S. Postal Service Annual Report, 2002*, p. 52, accessed on the Internet at <http://www.prc.gov/docs/37/37195/2002-annual-report.pdf>; and *Fortune*, April 14, 2003 issue, pp. F-1 to F-20.

This position was recently restated by John Nolan, the Deputy Postmaster General, in response to questions from Joseph Wright, a member of the President's Commission on the U.S. Postal Service. The Presidential Commission was established in late 2002 to consider what might be done to improve the Postal Service's bottom line and, more broadly, to examine what role the Postal Service should play in the 21st century. During the Commission's deliberations, Mr. Wright asked Deputy Postmaster General Nolan whether the Postal Service should be allowed to compete with private businesses in the commercial marketplace, given that it is an arm of the federal government and possesses a statutory monopoly in its core market. Mr. Nolan's reply, in essence, was that commercial ventures are entirely appropriate because he thinks they would help the Postal Service financially.

Serious questions can be raised about whether the Postal Service should continue to be a government-owned organization with a statutory monopoly in its core market. Most economists would argue on the basis of both economic theory and empirical observation of government enterprises throughout the world that productivity would be higher and the value of service greater if private firms, operating without special government favors, delivered the mail. But suppose that, for political or other reasons, the Postal Service remains part of the government and keeps its monopoly and many other government-derived privileges. Should it, as a government enterprise with numerous government-based powers, also be allowed to operate in non-monopoly markets, where its products compete directly against similar offerings by private-sector businesses?

For example, several private-sector companies furnish overnight letter and package delivery. Should the U.S. Postal Service also be in that product line? Should the Postal Service be dabbling with e-mail, e-commerce, and other Internet-based products when private-sector firms were there first and have already developed a rich variety of innovative products? Should post offices be selling retail products that thousands of other businesses, many of them small, already provide? Or, as another example, should post offices be selling packing supplies that compete head-on with private businesses that already offer retail packaging services?

In light of the Deputy Postmaster General's comments and the work of the Postal Commission, now is a good time to examine whether Postal Service ventures outside its core market benefit taxpayers, the Postal Service's monopoly-market customers, and the overall economy. On all counts, the findings are that an expansionary Postal Service is more a threat than an aid. In addition, because the Postal Service receives many advantages as part of the federal government — no income taxes, exemptions from many other taxes, full or partial exemptions from certain federal, state, and local regulations, federally subsidized borrowing privileges, no investors expecting it to earn profits, etc. — its presence in competitive markets is grossly unfair to the private-sector businesses against which it competes. Based on these findings, which are examined below, it is clear that captive-market postal customers, taxpayers, private businesses, and the economy's productivity would all benefit if the Postal Service were to leave competitive markets. It should certainly should not try to expand in those markets.

Of course, if the Postal Service were converted from government ownership to private ownership and if its special government privileges removed, it should then be treated like other private companies. If it became a private-sector enterprise without governmental prerogatives, it should then have the freedom to enter new markets as it wishes. The money that its owner-investors would voluntarily put at risk and their desire to earn profits would insure that it only entered a market if it believed it could offer at least as good a combination of cost and value as its competitors.

### **The Deputy Postmaster General's Comments**

In his response to Commissioner Wright, Mr. Nolan asserts that the Postal Service can more fully utilize its labor force and capital stock by operating in competitive markets and, indeed, should greatly expand its presence there. "The United States government has made a significant investment in its postal infrastructure... The ability to expand current products and services and to be allowed to branch out into related endeavors would ... help sustain the investment."<sup>3</sup> Later in his reply he says, "[G]iven that ... other recommended changes to the current Postal Service model are likely not adequate to provide the revenue and cost structure necessary to maintain financial viability, the Postal Service should be allowed to compete in the marketplace." The Deputy Postmaster General does not explicitly say why he believes operating in competitive markets helps the Postal Service financially and why he thinks expanding aggressively in those markets would increase its financial gains. Perhaps he is assuming that despite the Postal Service's huge size, it is not yet big enough to have realized all significant size-based economies of scale and scope. Or perhaps he thinks that although the Postal Service has usually lost money in the past on both monopoly-market and competitive-market products, it can readily earn profits on new competitive-market ventures. In any case, he views forays into competitive markets as a means for "covering more of its overhead costs by means other than higher ... rates".

Conversely, he warns that the organization would suffer from higher unit costs and squander its resources if sales of current products decline and if it is prevented from maintaining its size by expanding in competitive markets. "[D]eclining volumes and revenues, combined with an ever-increasing delivery network obligation, [may] cause the Postal Service to become non-viable due, in part, to an inability to broaden its product line and the services offered..."

The Deputy Postmaster General recognizes that this country has a tradition of relying on "private enterprise (rather than government) to solve [economic] problems creatively and effectively. The U.S. was built in no small part by entrepreneurs... [O]ur philosophy as a nation

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<sup>3</sup> John Nolan, "Postal Service Competition with the Private Sector (Deputy Postmaster General John Nolan)," provided in response to a request from Commissioner Joseph Wright, April 2, 2003, Presidential Commission on the United States Postal Service, accessed on the Internet at [http://www.treas.gov/offices/domestic-finance/usps/docs/response\\_to\\_wright.com](http://www.treas.gov/offices/domestic-finance/usps/docs/response_to_wright.com). The other quotes from Mr. Nolan in this section are also from this paper.

also dictates that the government should not unfairly compete with private enterprise." But he urges that an exception be made for the Postal Service because of its "subsequent evolution" since the Postal Reform Act of 1970, its financial neediness, "and the communications needs of the country."

What are some of the competitive-market product lines in which Mr. Nolan thinks the Postal Service should expand? "Appropriate areas," he says, "would include forward and backward integration from the current part of the supply chain covered by the Postal Service for hard copy acceptance, distribution, transportation and delivery; logistics and fulfillment services; internationally originating mail; mail-related retail services; and convenience items at retail." In the retail field, he notes with approval that "[s]elling greeting cards, packing services, soft drinks, passport photos, etc., are all examples of products or services offered by the Postal Service at retail ... to maximize the return on its retail investment..." More broadly, he declares, "The restriction that the Postal Service not be allowed to compete in areas where the private sector either already offers products and services, or could offer them, should not exist. This would be consistent with a national decision that supporting the investment in the postal infrastructure is sound public policy."

Deputy Postmaster General Nolan adds that private-sector businesses have objected to such competitive-market product offerings by the government-owned Postal Service. He complains that private-sector businesses are insensitive to the Postal Service's financial needs and fail to understand that ultimately postal expansion would "benefit all players." He claims he wants "as level a playing field as possible without losing the fundamental objective" of supporting the Postal Service's mission at minimum cost. However, Mr. Nolan calls, in effect, for a very unlevel playing field when he insists, "Maintaining the monopoly and [simultaneously] allowing the Postal Service to compete in a defined portion of the [competitive-product] marketplace are two important parts to the achievement of that objective."

Other top Postal Service officials have expressed similar sentiments, although usually not in such detail. For example, in introducing the Postal Service's "Transformation Plan" in April 2002, Postmaster General John Potter alluded to expansion when he called for a business model that "will allow us to leverage our vast retail and delivery assets to develop new revenue streams."<sup>4</sup> Among the expansion options the "Transformation Plan" mentions, two are letting the Postal Service provide commercial transportation services by "utilizing excess capacity on postal-owned and contract vehicles ... [to transport] nonmail items or mail that has not yet been inducted into the postal system" and permitting it to offer commercial "warehousing and merchandise fulfillment" services, especially if consolidation leaves it with excess space.<sup>5</sup> (A

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<sup>4</sup> John E. Potter, "Remarks of Postmaster General John E. Potter," National Press Club, Washington, DC, April 5, 2002, accessed on the Internet at [http://www.usps.com/strategicdirection/\\_txt/pmgnpfinal.txt](http://www.usps.com/strategicdirection/_txt/pmgnpfinal.txt).

<sup>5</sup> United States Postal Service, *United States Postal Service Transformation Plan*, April 2002, p. 23, accessed on the Internet at <http://www.usps.com/strategicdirection/transform.htm>.

superior option, however, might be working harder to keep capacity in line with needs. And if excess capacity does develop, reducing the excess through asset sales or attrition might be better policy than expanding the organization in order to try soaking up the excess capacity internally.)

Expansion is not a new idea at the Postal Service. In the mid 1990s, then Postmaster General Marvin Runyon frequently declared that the organization needed growth. "Folks, there isn't much of a future for us if we are only a cost-cutting organization. We also need growth. Growth that will help us cover our fixed costs. Growth that will fuel the ever-expanding national network. Growth that will allow us to reinvest in better service and higher productivity."<sup>6</sup> Runyon argued, as does Mr. Nolan, that the Postal Service should remain a government organization with governmental powers while gaining more freedom to expand its lineup of competitive-market products.

The Postal Service's efforts to expand in markets where private-sector firms already operate are nothing new. For instance, in its 1890 Annual Report, the Post Office Department argued that it should "do more than employ fast mails and stage coaches."<sup>7</sup> Dismissing as "specious" the "objection ... that the government ought not to compete with existing companies," it proposed to take control of all telegraph service within the nation to provide "cheaper telegraphy" and broader access, including "at points not profitable for private capital to reach."<sup>8</sup> It asserted, "The postal service is the Government's kind hand ... and communication by telegraph as well as by mail is essential to its best development."<sup>9</sup> A few years later it used similar reasoning to argue that it should take over the nation's telephone service, claiming it was looking out for "the welfare and happiness of the nation."<sup>10</sup> Unlike the posts in many other countries, the U.S. Post Office did not succeed in its efforts to expand by monopolizing telegraph and telephone services.

### **The Monopoly Market and Competitive Markets**

First-class and standard mail, both sheltered by pro-monopoly legislation, are the heart of the Postal Service. In 2002, they provided the Postal Service with \$52.3 billion of revenue, and accounted for 79% of total Postal Service operating revenue of \$66.5 billion.<sup>11</sup> (For the year,

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<sup>6</sup> Marvin Runyon, Remarks at the 1997 NAPUS National Convention, at Philadelphia, PA, August 25, 1997, originally accessed on the Internet at <http://www.usps.gov/speeches/97/082597a.htm>.

<sup>7</sup> U.S. Post Office Department, *Annual Report Of The Postmaster-General Of The United States, Fiscal Year 1890* (Washington, DC: Government Printing Office, 1890), p. 7.

<sup>8</sup> *Ibid.*, pp. 8-9.

<sup>9</sup> *Ibid.*, p. 8.

<sup>10</sup> U.S. Post Office Department, *Post Office Department Annual Report, 1914* (Washington, DC: Government Printing Office, 1913), p. 15.

<sup>11</sup> U.S. Postal Service, *Annual Report, 2002, op. cit.*, pp. 52, 54.

first-class and standard mail revenue increased by \$0.7 billion, or 1.4%, and total operating revenue increased by \$0.6 billion, or 1.0%).<sup>12</sup>

Most other Postal Service products lie outside the statutory monopoly, and with them the government entity usually finds itself in head-to-head competition with private-sector businesses offering similar wares.<sup>13</sup> The Postal Service's output and revenues in competitive markets are small relative to its total revenues (about 20%, or less). Nevertheless, the Postal Service is so massive that its competitive-market revenues total billions of dollars yearly. The Postal Service's competitive-market sales would, by themselves, place the Postal Service well within the Fortune 500 if they were the revenues of a free-standing company. Further, if the Deputy Postmaster General and other expansionists have their way, its presence in competitive markets will grow rapidly.

Consider some of the competitive-market products that the Postal Service currently offers.

- One of the largest and most familiar competitive-market categories, and one where the Postal Service would like to grow, is overnight mail delivery. While the Postal Service entered this market early, it was an innovative private-sector business that first developed the procedures for making it a commercial success.

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<sup>12</sup> *Ibid.*. Several special services (registered mail, certified mail, special receipt services, and post-office-box rentals) are rarely used except in conjunction with sending or receiving first-class mail. If these special services are included in monopoly revenues, they would bring that amount to \$54.2 billion, which is 82% of total Postal Service revenues.

<sup>13</sup> A gray area is delivery of magazines, newspapers, and other periodicals. Although private firms are allowed to deliver these publications door-to-door, they cannot place them in people's mailboxes; only the Postal Service can do that. Some periodicals, notably local newspapers, are delivered door-to-door without using mailboxes, but for most publications the mailbox restriction has proven a significant barrier to private delivery. For example, Publishers Express, which Time Warner started in the early 1990s as a private-sector business delivering subscription magazines, closed its doors in 1996. Shortly thereafter, Postmaster General Marvin Runyon boasted, "Remember the alternate delivery company called Publishers Express... We ran them out of business... I can't say that I am sorry to see them go... [W]hen we get our act together, we can be one hell of a competitor." (Marvin Runyon, "Remarks by Postmaster General Marvin Runyon before the NAPUS Leadership Conference," Washington, D.C., February 20, 1996, originally accessed on the Internet at <http://www.usps.gov/news/speeches/96/022096sp.htm>.) Although Mr. Runyon claimed the Postal Service crushed its rival with low costs and improved service, H. Edward Quick, then a member of the Postal Rate Commission, pointed in Congressional testimony to the anti-competitive mailbox monopoly. (H. Edward Quick, Jr, "Trilogy Of Woes Demands A Reality Check," Testimony before the Subcommittee on Postal Service, Committee on Government Reform and Oversight, U.S. House of Representatives, March 13, 1996, accessed on the Internet at <http://www.prc.gov/docs/33/33400/Quick.pdf>.) Private-sector delivery services are further handicapped in this market because the Postal Service's mark-up on periodicals is extremely low. In rate cases, the Postal Service asks that periodicals just barely cover their attributable costs.

- Another large and well known category is parcel delivery. The U.S. Post Office started its parcel post service only in 1913, after watching the success of private-sector companies in that market.<sup>14</sup> Before then, the Post Office had provided very limited service for packages.
- Pre-paid telephone calling cards are another of the Postal Service's competitive-market products. Perhaps to associate the telephone calling cards with traditional postal activities, the Postal Service calls them FirstClass Phonecards, although, in truth, pre-paid phone cards have nothing to do with mail service.
- The Postal Service is desirous of expanding into new modes of communication and has its eye on the Internet. One of its Internet-based products it is currently promoting on its website is an on-line bill payment service that it calls USPS eBillPay and which it describes as "like having an electronic checkbook in your computer."<sup>15</sup>
- A related product, for electronic money transfers, is USPS Send Money. Among its uses, says the Postal Service, is to "send money to your child at college, send your sister money for your parents' anniversary gift, or pay for a purchase at an online auction site."<sup>16</sup>
- In the area of e-mail, the Postal Service sells USPS Electronic Postmark (EPM) to verify when e-mail was sent and who sent it "through the use of auditable time stamps, digital signatures and hash codes."<sup>17</sup> At one time, the Postal Service floated a sweeping proposal to take over the Internet top-level domain ".us".<sup>18</sup> A Postal Service spokesperson claimed that controlling part of the Internet would be a natural fit for the organization "because of our experience managing address systems."<sup>19</sup>

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<sup>14</sup> See U.S. Post Office Department, *Post Office Department Annual Report, 1912* (Washington, DC: Government Printing Office, 1913)

<sup>15</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/paymentservices/psconsum.htm>.

<sup>16</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/paymentservices/pspaymnt.htm>.

<sup>17</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/electronicpostmark/welcome.htm>.

<sup>18</sup> See Jeri Clausing, "Postal Service Proposes Using '.us' Domain For Individuals," *New York Times*, August 5, 1998. For the text of the proposal, see James Gleve, "Postal Service Eyes .us Domain," *Wired News*, June 19, 1998, at [www.wired.com/news/print\\_version/politics/story/13129.html?wnpg=all](http://www.wired.com/news/print_version/politics/story/13129.html?wnpg=all). For a discussion of some of the concerns raised by the Postal Service's move into cyberspace, see James P. Lucier, "Dangers In Cyberspace," in Edward L. Hudgins, ed., *Mail @ The Millennium: Will The Postal Service Go Private?* (Washington, DC: Cato Institute, 2000), pp. 45-66. For instance, some fear that if the Postal Service controls the electronic transmission of supposedly confidential documents, it will not adequately protect people's privacy rights from prying eyes elsewhere in the government.

<sup>19</sup> Clausing, *op. cit.*



- The Postal Service urges you to buy greeting cards on-line at its NetPost CardStore because "[t]here's no better way to make a personal connection than with a beautifully printed card."<sup>20</sup>
- For wire transfers to Mexico, the Postal Service suggests you choose their DineroSeguro service.<sup>21</sup>
- The Postal Service sells an expedited international shipping service for time-sensitive packages and documents that it calls Global Express Guaranteed and provides through an affiliation with DHL Worldwide Express.<sup>22</sup>
- Many post offices sell bubble wrap, boxes, and other packing supplies that compete head-on with private businesses that already offer retail packaging services.<sup>23</sup>
- For a while, many Post Office lobbies were selling T-shirts, mugs, stationery, key chains, greeting cards, earrings, puzzles, and (in the words of a Postal Service flyer) other "gift and souvenir ideas". After vigorous protests, then Postmaster General William Henderson ordered that most of the merchandise be removed from Post Office lobbies, declaring it "is not...something that we ought to be doing."<sup>24</sup> But, today, in addition to the phone cards and packing supplies mentioned above, post office lobbies carry items like tote bags, teddy bears, and drinking mugs.<sup>25</sup>
- The Postal Service also aspires to be "[y]our single source for magazine subscriptions." It "is pleased to offer you thousands of magazines at savings of up to 85% off retail prices" through an affiliation with Magazine Mall, Inc.<sup>26</sup>

In all these cases, the Postal Service is supplying a product that is already available in similar form from the private sector. Thus, in none of these cases can the Postal Service claim that it is delivering a valuable product because the private sector is unable to do so. On the contrary, with competitive-market products, private businesses usually pioneered making the

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<sup>20</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/netpost/cardstore/>.

<sup>21</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/money/sendingmoney/wiremoneytomexico/welcome.htm>.

<sup>22</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/global/globalexpressguaranteed.htm>.

<sup>23</sup> An extensive array of packing supplies were observed in multiple post office lobbies in the Washington, D.C. area in May 2003.

<sup>24</sup> See Bill McAllister, "Postal Merchandise Sales Put In Dead Letter Box; Postmaster General Curbs Retailing Scope," *The Washington Post*, August 13, 1998, p. A13.

<sup>25</sup> The Postal Service tries to create a connection between these items and mail service through the use of postal logos. For example, the teddy bears they sell have stamp-like designs stitched on their bellies and postage stamps in plastic holders chained to their heads.

<sup>26</sup> Seen on the Postal Service website on May 7, 2003 at <http://www.usps.com/magazines/>.

products into commercial successes and are generally rated higher than the Postal Service in terms of technology and quality of service.

### **Possible Rationales For The Postal Service Being In Competitive Markets**

Assuming the Postal Service continues in its core business of delivering first-class and standard mail, are there benefits if it also operates in competitive markets?

It cannot convincingly be argued that the Postal Service is supplying competitive-market products because no one else will. Postal Service products like overnight delivery, electronic bill payment, e-mail authentication, and retail merchandise are similar to products already available from private firms.

Nor is it likely to be argued that the Postal Service is in competitive markets because government enterprises are normally more efficient and better at controlling costs than private firms. Experiences in this country and around the world point in the opposite direction. At the Postal Service itself, top management acknowledges that the organization has serious cost problems. One of its worst difficulties is high labor costs per worker. Most economists studying the issue have concluded that, on average, postal employees receive wages at least 20% above what they would earn in the private sector. When fringe benefits are included, the postal pay premium may top 35%.<sup>27</sup> Because the Postal Service is so labor intensive (about 80% of its expenses are labor related), the postal pay premium increases its costs by billions of dollars every year.<sup>28</sup> The Postal Service's high labor costs are a major handicap whenever it tries to compete with private-sector businesses. They are a good reason for the Postal Service to *exit* markets outside of its protected monopoly, not enter them.

Another argument for expansion that is not likely to be made is that the Postal Service is showing the nation the way in terms of cutting-edge technology and product innovation.

Instead, the main argument for Postal Service activities outside its monopoly seems to be that in various ways the activities supposedly benefit monopoly-market customers by somehow keeping rates down.

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<sup>27</sup> For a fuller discussion of this issue, notably a survey of empirical economic studies in the area, see Michael Schuyler, "The Postal Wage Premium: No Wonder The Postal Service Loses Money," *IRET Congressional Advisory*, No. 131, July 24, 2002, available on the Internet at <ftp://ftp.iret.org/pub/ADVS-131.PDF>. Saying that postal workers, on average, receive much higher compensation than similar private-sector workers does not, of course, mean that every postal worker or every category of postal workers obtains a premium compared to what he or she would receive in the private sector.

<sup>28</sup> For a rough estimate of the dollar magnitude, suppose the postal pay premium is initially 30% and suppose, magically, it is reduced to 10%. That would have saved the Postal Service about \$8 billion in 2001 alone. (*Ibid.*)

Economies of scale and scope. If the Postal Service captures additional economies of scale and scope as it grows larger, the unit costs of first-class and standard mail would fall as the organization expands. In assessing this argument, though, it is useful to remember that the Postal Service is already a giant organization, with 2002 revenues of \$66.5 billion and 854,000 total employees.<sup>29</sup> Only ten U.S. companies had higher sales and only one had more employees.<sup>30</sup> Former Postmaster General William Henderson was correct several years ago when he said, "Sometimes we don't appreciate how big the Postal Service really is."<sup>31</sup> Thus, the issue is not whether economies of scale are attained in growing from small to large but whether an already enormous enterprise continues to reduce marginal costs by growing yet larger.

That is not the pattern observed in most industries. Even in industries where economies of scale and scope are very pronounced, firms are usually large enough to capture the economies by the time they reach the multi-billion dollar range. That is why many industries have several major firms in fierce rivalry instead of one huge firm filling the industry. (If growth-related economies did not typically have limits, the biggest firm would tend to have the lowest marginal cost and could underprice smaller firms by progressively larger amounts as it grew and they shrunk. Eventually, the largest firm would have the industry to itself.) As another reality check, if size-based economies were typically very important, mergers and acquisitions, which almost by definition increase firm size, should normally be rousing successes. Instead, they often fail. A widely cited study by KPMG International looked at a sample of mergers that occurred between 1996 and 1998 and determined that only 17% increased shareholder value at the acquiring company, while 30% had no significant effect and 53% actually reduced shareholder value.<sup>32</sup>

A possible rejoinder is that maybe non-urgent letter delivery is a special case because perhaps it is a natural monopoly like a water or gas utility. The difference, however, is that whereas those utilities must often construct very expensive, extremely high-capacity distribution systems, the Postal Service has its distribution system already waiting: the nation's highways, rail lines, airways, and waterways.<sup>33</sup>

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<sup>29</sup> U.S. Postal Service, *Annual Report, 2002*, *op. cit.*, pp. 51, 54.

<sup>30</sup> *Fortune*, *op. cit.*

<sup>31</sup> U.S. Postal Service, *1996 Annual Report*, (Washington, DC: United States Postal Service, 1997), p. 11.

<sup>32</sup> KPMG, *Unlocking Shareholder Value: The Keys To Success / Mergers & Acquisitions: Global Research Report 1999*, 1999, accessed on the Internet at [http://www.kpmgconsulting.co.uk/research/othermedia/mai\\_keys.pdf](http://www.kpmgconsulting.co.uk/research/othermedia/mai_keys.pdf).

<sup>33</sup> The introduction of deregulation and spread of competition in the telephone and electric industries indicates that the natural monopoly argument may have been overused even in some cases where the classic conditions for a natural monopoly seemed to be met.

The Postal Service's own actions also cast doubt on the economies of scale and scope argument. If economies of size dominated, the huge Postal Service would want to do as much work as possible in-house for two reasons. First, it would have lower unit costs than smaller outside firms, and, second, could reduce its unit costs still further by doing more.<sup>34</sup> Instead, it frequently contracts out work because private companies often have lower costs, notwithstanding their small size compared to the massive Postal Service. Thus, for example, it offers work-sharing discounts to mailers who help with sorting and transportation. These worksharing discounts, which result in a *smaller* Postal Service (less work is done in house), are estimated by economists at the Postal Rate Commission to produce huge cost savings — "\$15.3 billion or nearly one quarter of total USPS costs" in 1999.<sup>35</sup> And in another initiative to lower its costs by outsourcing work, the Postal Service signed an agreement with Federal Express in 2001 under which it pays FedEx to handle the air transportation of express mail, priority mail, and some first-class mail.<sup>36</sup> With many of its competitive market products, from phone cards to greeting cards to magazine subscriptions to its international delivery services, the Postal Service partners with much smaller firms. The smaller firms provide specialized expertise and do much of the work while the Postal Service sells its government-backed brand name and provides a small amount of space in post office lobbies or on its website. The Postal Service is certainly not acting like a firm that believes it can lower its unit costs by doing more.

A modest, size-based cost economy may be present in the trip to the mailbox. Carrying five letters to the mailbox has a lower unit cost than carrying one.<sup>37</sup> But this going-to-the-mailbox scale economy usually does not apply to the Postal Service's competitive-market products. Some, like package delivery, often require separate trips to the mailbox, and others, like e-mail, do not involve mailbox deliveries at all. In addition, the Postal Service is so highly specialized for delivering items with the size, weight, and handling requirements of letters, from the layout of postal vehicles to the size of mailpouches, that attempting to deliver items with different characteristics along with normal mail tends to slow carriers significantly and nullify potential economies of scope.

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<sup>34</sup> See the discussion of this issue in Sidak and Spulber, *op. cit.*, ch. 3.

<sup>35</sup> Robert H. Cohen, William W. Ferguson, John D. Waller, and Spyros S. Xenakis, and Appendix by Edward S. Pearsall, "The Impact Of Using Worksharing To Liberalize A Postal Market," white paper presented at a Wissenschaftliches Institut für Kommunikationsdienste GmbH (WIK), 6th Koenigswinter 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>.

<sup>36</sup> See U.S. Postal Service, Press Release, "Postal Service, Fedex Reach Agreement on Business Alliance," January 10, 2001, accessed on the Internet at [http://www.usps.com/news/2001/press/pr01\\_alliance0110\\_print.htm](http://www.usps.com/news/2001/press/pr01_alliance0110_print.htm).

<sup>37</sup> See John C. Panzar, "The Economics Of Mail Delivery," in *Governing The Postal Service*, J. Gregory Sidak, ed. (Washington, DC:AEI Press, 1994).

Finally, if economies of scale and scope really dominated, why don't we observe it with private delivery companies? Tellingly, a number of private delivery companies all much smaller than the Postal Service are large enough to have achieved the cost efficiencies that enable them to compete vigorously. If size-based economies accumulated whenever firms grew, there should be only be one private carrier of express letters and one company (perhaps the same one) delivering all freight. In reality, in both areas several private companies are large enough to have achieved the cost efficiencies that enable them to compete vigorously. Similarly, there should be one vast national company that makes all home deliveries of restaurant meals when, in fact, several national restaurant chains and many small, local establishments furnish delivery service.

Is the Postal Service's core market about to implode? A variation on the previous argument is that the Postal Service's core market will soon shrink because of a growing array of communications alternatives. To avoid a death spiral of falling volume and rising marginal cost, this argument goes, the Postal Service needs to replace what it loses in its core market with higher volume in other product lines.

Certainly, 2001 and 2002 were very difficult years for the Postal Service. The combination of economic recession, September 11, and mail-delivered anthrax attacks combined to produce a sudden, sharp fall in mail volume. Drops in mail volume are not unknown, but they are rare, because the Postal Service's statutory monopoly in its core market of non-urgent letter delivery shelters it from direct competition by rival producers. The prior two declines in mail volume occurred in 1991 and 1975, both periods of recession, and the last time mail volume declined for two years in a row was during the Great Depression.<sup>38</sup> Despite lower mail volume, though, the Postal Service's revenues rose in both 2001 and 2002. The organization, protected by its core-market monopoly, has not experienced a revenue decline since 1946.<sup>39</sup> Fortunately, the economy has resumed growing, albeit slowly, population is rising (more potential mail customers), and the anthrax attacks have not been repeated. Accordingly, the Postal Service expects mail volume to grow in 2003 and 2004<sup>40</sup>, and revenues to continue increasing.

A longer-term concern for the Postal Service is diversion of hard-copy mail to electronic alternatives like the Internet and direct deposit. "[E]lectronic diversion continues to eat slowly

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<sup>38</sup> U.S. Postal Service, *Annual Reports*, various issues; U.S. Post Office Department, *Annual Reports*, various issues.

<sup>39</sup> *Ibid.*

<sup>40</sup> U.S. Postal Service, "2002 Comprehensive Statement On Postal Operations," pp. 43-44, accessed on the Internet at [http://www.usps.com/history/cs02/usps\\_cs2002.pdf](http://www.usps.com/history/cs02/usps_cs2002.pdf). Underscoring the dependence of mail volume on economic activity, however, the Postal Service now predicts less growth than it did previously due to a weaker-than-expected recovery. (See U.S. Postal Service, "FY 2003 Quarter II, Financial Conditions & Results," accessed on the Internet at [http://www.usps.com/financials/\\_pdf/2003Q2.pdf](http://www.usps.com/financials/_pdf/2003Q2.pdf). Total mail volume increased 1.5% in the first quarter of 2003 and was flat in the second quarter.)

into the market share of the letter-size mail products."<sup>41</sup> The Postal Service readily acknowledges, though, that it is difficult to predict to what extent electronic alternatives will ultimately affect mail volume because they present both "opportunities and threats... The opportunities come in the form of increased markets for [some] mail products... In addition, recent advances in computing and communications technologies have made the mail an even more efficient medium for direct marketing."<sup>42</sup>

Still, the Postal Service's best guess is that electronic media have had a negative effect on mail volume,<sup>43</sup> although it observes that there has so far been less diversion than many forecasts predicted because of "a lower than expected adoption of electronic services by consumers."<sup>44</sup> The Postal Service believes electronic diversion will have a greater impact on mail volume five or ten years in the future.

The picture that emerges is of a significant but temporary drop in volume in the short run, recovery along with the economy, and then slow volume growth or perhaps a modest volume decline in the long run. However, when making long-run predictions about mail volume, it is worth remembering as the Postal Service itself points out that, "Throughout its history, the Postal Service has faced competitive threats from many alternative messaging media. Earlier alternatives include the telegraph, the telephone, and the facsimile machine... In spite of the introduction of these competitive messaging media ... mail volumes have continued to grow over time."<sup>45</sup> Moreover, if electronic diversion is really such a body blow, how are private-sector companies that derive significant revenues from express delivery of documents able to prosper despite facing traditional electronic alternatives like the phone and fax and newer ones like e-mail and software programs such as Adobe Acrobat?

The Postal Service's response to the short-run trauma has been to embark on an aggressive campaign of cost cutting under the leadership of Postmaster General John Potter. Although such behavior is common at private-sector companies under stress, it is an extraordinary accomplishment at a government agency. The cost cutting enabled the agency to trim its loss from \$1.7 billion in 2001 to \$676 million in 2002.

Prudent cost management would be excellent policy in the long run, too, whether or not volume declines. It would make mail service that much more affordable. In addition, good cost

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<sup>41</sup> *Ibid.*, p. 44.

<sup>42</sup> U.S. Postal Service, *Transformation Plan*, *op. cit.*, p. E-1.

<sup>43</sup> *Ibid.*, p. E-2.

<sup>44</sup> *Ibid.*, p. E-7.

<sup>45</sup> *Ibid.*, pp. E-1, E-2.

management has a positive feedback on mail volume: cost savings hold down rates, and lower rates encourage higher volume.

If there is eventually a modest decline in volume, unit costs need not rise, provided the Postal Service is allowed to gradually adjust its physical plant and workforce (mostly through attrition) to changes in volume. Because the Postal Service is more than large enough to have captured all major economies of size, it could continue to realize those size-based economies if it were somewhat smaller. Congress could help immensely here by giving the Postal Service more control over its labor costs and interceding less when the Postal Service attempts to better manage its capital stock through actions like rationalizing the locations of its processing facilities.

But couldn't the Postal Service avoid ever having to worry about volume decreases just by moving farther into competitive markets? In reality, that would be a jump from the frying pan into the fire. Competitive markets are extremely volatile. Because many producers offer similar products in direct competition, individual companies' sales often bounce violently from one year to the next, and sales declines are common. In 2002, 44% of the companies on the Fortune 500 posted lower revenues than the year before. In 2001, 42% of the companies suffered revenue drops.<sup>46</sup> In contrast, with its protected core market, the Postal Service recorded higher revenues both years. If the Postal Service does not think it can withstand even a small, gradual decline in sales sometime in the future, that is a compelling reason to *avoid* competitive markets, not seek them out.

The expanding-mail-delivery-network argument. The Postal Service regularly complains that it is burdened by the costs of having to serve a growing number of households and businesses. Its most recent Annual Report comments, "Delivery point growth requires the equivalent of hiring 3,000 new carriers each year as well as purchasing new vehicles and building or leasing new facilities... However, mail volume has not grown sufficiently in recent years to provide the revenue that supports extension of our delivery and retail network."<sup>47</sup> The Postal Service argues that it needs multiple changes, including being allowed to expand in competitive markets, to finance the cost of delivering mail to more addresses. As cited earlier, Mr. Nolan warns that "an ever-increasing delivery network obligation" is among the factors that could "cause the Postal Service to become non-viable" in the future unless it is allowed to "broaden its product line and the services offered".<sup>48</sup>

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<sup>46</sup> *Fortune*, April 15, 2002 and April 14, 2003 issues. These percentages understate the sales declines because they do not include firms whose sales fell so much from the previous year that they dropped off the Fortune 500.

<sup>47</sup> U.S. Postal Service, *Annual Report, 2002*, *op. cit.*, p. 19.

<sup>48</sup> Nolan, *op. cit.*

This argument is flawed at several levels. First, if the Postal Service is really weighed down by the cost of expanding its mail delivery network, wouldn't it just be adding to its woes if it also tries to finance an expansion in competitive-product markets? In other words, if the Postal Service finds expansion to be a burden, it would seem foolhardy for it to want to expand in competitive markets.

Second, if the Postal Service enjoys broad-based scale economies when it becomes larger, it should welcome more delivery addresses because much of that is due to population growth, which means more mail customers. The last two years have been exceptions, but in most years mail volume increases faster than the number of delivery points. The Postal Service's complaints about the burden of having to serve a growing number of homes and businesses provide additional evidence that it does not enjoy broad-based scale economies.

But might new postal facilities provide an opportunity to realize significant economies of scope; in other words, could new postal facilities and their workers at little additional expense provide a range of other goods and services along with non-urgent letter delivery? For example, do letter carriers have the equipment and training to efficiently deliver eggs, milk, and other groceries along with first-class and standard mail? Or while delivering mail could they also provide armored car service? Could mail clerks easily shift, for instance, to designing Internet websites during slow periods of mail processing? Clearly the answer is almost always "no". As noted earlier, the specialized training, equipment, and procedures used to deliver non-urgent letters are not easily carried over to most other tasks. Economies of scope are very limited.

The virtual absence of untapped economies of scale and scope greatly weakens the case for trying to become larger by expanding in competitive-product markets.

Third, the Postal Service is exaggerating the costs of expanding the number of its mail delivery points by emphasizing their costs while downplaying the revenues they generate. Some new routes operate at a profit, which means they are a benefit to the Postal Service rather than a burden.<sup>49</sup>

The sure-fire-commercial-success hypothesis. Some private-sector companies have been extremely successful in markets where the Postal Service would like to expand. But should the Postal Service expect to do as well in those markets?

A comment by former Postmaster General William Henderson suggests that many people at the government enterprise view competitive markets as extremely inviting and easy pickings financially. "The magnitude of the Postal Service's task dwarfs the dramatically lighter load that

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<sup>49</sup> This point was made by Robert Cohen, chief economist at the Postal Rate Commission, when he presented "The Cost Of Universal Service In The U.S.," at the AEI Conference on the Mission of the Postal Service and the Universal Service Obligation, Washington, D.C., April 30, 2003.



two of our well-known competitors [UPS and FedEx] carry...It's a race where they gladly concentrate on *short sprints with big payoffs*, but we are mandated to run the *unrelenting marathon* of universal service at uniform prices. [emphasis added]"<sup>50</sup>

If the Postal Service actually earned "big payoffs" in competitive markets, it could, if it wished, use those profits to cross-subsidize the "unrelenting marathon" of its core business. But there are several reasons to be skeptical that the Postal Service would realize average, let alone high, profits in competitive markets.

One fundamental problem is that private-sector investors jump in when they see a good profit opportunity and continue jumping in until they have driven the expected return down to the market average. Thus, good business opportunities are often temporary, and the advantage goes to quick-footed investors and companies. The Postal Service might be described as steady and big, but almost never as quick-footed.

To be sure, a business does not have to be first in to do well with a product. A business can still earn high profits if it is unusually good at developing product improvements, has better production methods than its rivals, or is better at marketing its products. The Postal Service, however, has not demonstrated an edge over private-sector companies in any of these areas.

Other problems for the Postal Service are that it has high labor costs (the postal pay premium discussed earlier), smaller gains in productivity than the private sector has averaged<sup>51</sup>, and often faces political constraints when it seeks to improve itself in these areas. (These problems explain why the Postal Service can realize large savings through worksharing arrangements that turn over some mail processing activities to private-sector companies.)

Despite these weaknesses, the Postal Service does possess numerous tax exemptions and other government privileges. These hidden government subsidies may give it enough of an edge to earn profits on some products. (Even if that happens, though, the economy will generally lose because, as discussed in a later section, the relatively inefficient Postal Service will be displacing more productive private-sector enterprises.) Often, however, despite its hidden government subsidies, the Postal Service will spill red ink when it tries to challenge more efficient, aggressive private-sector companies in competitive markets.

Not surprisingly, the Postal Service has lost money on a number of its competitive-market products. For example, it was reported in early 2002 that the Postal Service was discontinuing its PosteCS international e-mail service after it had rung up costs of \$7 million against new

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<sup>50</sup> U.S. Postal Service, *U.S. Postal Service Annual Report, 1996*, *op. cit.*, p. 6.

<sup>51</sup> For a discussion of this, see Michael Schuyler, "The Postal Service's Productivity Problem," *IRET Congressional Advisory*, No. 137, October 7, 2002.

revenues of only \$8,000.<sup>52</sup> The Postal Service also received a dose of reality in December 2001, when the U.S. General Accounting Office (GAO) issued a report on the Postal Service's overall electronic commerce initiatives. Although the Postal Service had 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."<sup>53</sup> An earlier GAO study, in late 1998, had reported on 19 new competitive-market products that the Postal Service introduced in the mid 1990s.<sup>54</sup> The GAO found that 15 of the 19 new products lost money, with cumulative losses of \$88 million on revenues of \$267 million.

The Postal Service's high labor costs, lack of expertise in areas beyond non-urgent letter delivery, and institutional mentality probably explain why it often finds that, despite its tax exemptions and other government privileges, it is a high-cost producer of competitive-market products and can lower its costs by outsourcing much of the work back to the private sector. For example, the Postal Service reports that it has outsourced its Electronic Postmark e-mail verification service to "a private sector company, AuthentiDate, where marketing and operating expenses were reduced by over 90 percent."<sup>55</sup>

At times the Postal Service may wrongly assume that pushing up revenues by selling more products necessarily helps it financially. Deputy Postmaster General Nolan suggests this confidence that revenues cover costs when he says, "To the extent that erosion in mail volume results in the costs of the USO [universal service obligation] becoming too great a burden for the mail remaining in the system, ways must be developed to ... provide the Postal Service with alternative means to generate revenue to cover the costs..."<sup>56</sup> In reality, added sales help financially only if extra revenues exceed extra costs. If added sales increase revenues by less than they boost costs, they hurt financially.

Sub-market returns may not overly bother the Postal Service because it may be content with a return that a private firm would find unacceptably low. But that leads to the issue of why the

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<sup>52</sup> The Postal Service's discontinuance of PosteCS is mentioned in Rick Brooks, "UPS Will Cease Document Delivery Via The Internet," *Wall Street Journal*, April 10, 2002, p. B4.

<sup>53</sup> 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](http://www.gao.gov/new.items/d0279.pdf).

<sup>54</sup> U.S. General Accounting Office, "Development and Inventory of New Products," GAO Report No. GAO/GGD-99-15, November 1998.

<sup>55</sup> U.S. Postal Service, "2002 Comprehensive Statement On Postal Operations," *op. cit.*, p. 60.

<sup>56</sup> Nolan, *op. cit.*

presence of the Postal Service in competitive markets is likely to be contrary to the national interest.

### **Dangers From Postal Service Activities In Competitive Markets**

The Postal Service's operations in competitive markets are damaging at several levels. They are a threat to customers in the Postal Service's captive market, who may be forced to cross-subsidize the entity's forays into competitive markets. They are also a threat to taxpayers, who may have to pay for a bail-out if the Postal Service suffers major financial reverses. Further, because the Postal Service is happy to break even while private firms strive to earn profits, the Postal Service's competitive-market activities reduce the economy's productivity by displacing more efficient private production with less efficient Postal Service production. In addition, Postal Service operations in competitive markets are unfair to private-sector businesses that must pay a host of government taxes and fees and obey numerous government regulations from which the Postal Service, as a government entity, is exempt.

A less productive economy. Private-sector businesses seek profits. They need to because they are accountable to their shareholders, and shareholders want to earn market rates of return (or better) on their investments. As Adam Smith noted in his invisible hand analogy, the pursuit of profits motivates businesses to act in the public interest. Businesses must be attentive to their customers' wants because they can sell desired products in greater quantities and at higher prices than less desired products; that means greater profits. Profits also give businesses a strong incentive to ferret out waste in production and devise new, more efficient production techniques because, other things equal, profits rise when costs fall. Minimizing costs means getting the most value and output out of the available resources.

The Postal Service, in contrast, is asked only to break even. Breaking even does require some attention to costs and product desirability, but much less than if the objective is to earn a competitive rate of return. Suppose, for instance, that a private firm spends \$10 to produce a product that it sells for \$11, giving it a 10% return. Because the Postal Service is content to break even, it could use \$1 more of scarce production inputs than the private firm to produce the same output and still meet its financial objective. (Revenues and costs would both be \$11.) The Postal Service would also meet its financial objective if it used the same inputs as the private firm but produced a less desirable output that could only be sold for \$10, instead of \$11. Either way, scarce production inputs are being wasted, with the result that the economy's output of goods and services is less because Postal Service production is displacing more efficient private-sector production. Notwithstanding the loss of aggregate output, the Postal Service would view the displacement as a success because it would be meeting its break-even target.

Perversely, the Postal Service's break-even constraint encourages expansion even as it provides a cushion for inefficiency. You can expand a lot farther if you only need to break even than if you strive for a market rate of return.

Hidden government subsidies. The productivity gap attributable to the difference between earning a competitive return and breaking even is greater than it might seem because, in measuring break even, the Postal Service receives a free pass on many government taxes and regulations that private-sector firms must pay and observe. The Postal Service pays no federal income tax, no state or local income taxes, no state or local sales or gross receipts taxes, no property taxes on land, buildings and equipment it owns, no motor vehicle licensing and registration fees, and no parking tickets.<sup>57</sup> It does not pay unemployment compensation taxes but only reimburses the government for unemployment benefits that eligible former employees draw.<sup>58</sup> It is exempt from local zoning regulations (although it tries to cooperate, if possible); has the power of eminent domain (although it uses it sparingly); and it has argued that it is at least partially exempt from anti-trust laws even outside its statutory monopoly (although that is currently being tested in the courts). It can borrow at an interest rate hundreds of basis points lower than a private company with comparable finances would have to pay because of its ability to tap into the U.S. Treasury.<sup>59</sup>

The money the Postal Service saves because it is exempt from this array of government-imposed charges gives it additional leeway to use an excess of scarce production inputs in production. That is, for every dollar the Postal Service saves in government charges that a private company would have to pay, it can waste an extra dollar in inefficient production.

The presence of a government entity in competitive markets that is willing to accept below-market returns and that receives hidden government subsidies is obviously unfair to the private firms against which the Postal Service competes. Less obviously, it is also unfair to states and localities. When the Postal Service produces a competitive-market product instead of a private firm, state and local tax bases shrink because of the Postal Service's multiple exemptions. This open-ended subsidy to the Postal Service's competitive-market products victimizes state and local government taxpayers, who must make do with fewer state and local government services, or pay higher taxes.

The threat to monopoly-market customers. Supposedly, each type of Postal Service product is priced so as to cover the costs for which it is responsible and also make a reasonable

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<sup>57</sup> Recently, for instance, an Assistant County Attorney issued a legal opinion saying she would not prosecute any parking citations issued to Postal Service vehicles because the federal laws under which the Postal Service operates, affirmed by court decisions, take precedence over local parking ordinances. (See Carl Orth, "Post Office Makes Carriers Park, Walk To Mailboxes," *Suncoast News*, April 27, 2003, accessed on the Internet at <http://pasco.tbo.com/pasco/MGAZKBDGOFD.html>.)

<sup>58</sup> United States Code, Title 5, Chapter 85.

<sup>59</sup> For rough estimates of the dollar magnitude of several of the Postal Service's hidden subsidies, see Michael 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 study does not estimate the value of the postal monopoly.

contribution to overhead costs (costs not attributable to any particular product). On the surface, this would seem to safeguard users of the Postal Service's monopoly products from having to subsidize the Postal Service's competitive-market products. Cross-subsidization could still occur, however, if (1) some of the costs of a product are misidentified as attributable to another product or (2) if some of the costs of a product are miscategorized as overhead expenses, with the products that furnish the subsidies picking up those "common" costs.

The generous share of its total costs that the Postal Service classifies as institutional is consistent with the second method of cross-subsidization. In 2001, for example, the Postal Service claimed that over 37% of its costs were overhead costs unrelated to specific products (technically called institutional costs).<sup>60</sup> In that year, first-class mail comprised just under 50% of total mail volume, but it was forced to cover a much larger share, 68%, of total contributions to overhead costs.<sup>61</sup> The heavy burden on first-class mail consumers can also be seen in the very high "markup" placed on first-class mail. Postal rates on each category of mail are "marked up" above that category's direct costs in order to help cover the Postal Service's overhead costs. In the last major rate case, the markup on first-class mail was 90.1%. That is over twice the 43.9% average markup that was authorized for the Postal Service's other products and services.<sup>62</sup>

Provided that the Postal Service as a whole breaks even, Postal Service managers and employees actually have an incentive to expand into competitive markets at a loss and cover the losses by overcharging monopoly-market customers because rewards for those in the Postal Service may be more closely tied to the size and growth of the organization than its financial performance. An expanding Postal Service, for instance, means new job openings and more opportunities for advancement. Thus, although the Postal Service usually defends its competitive-market forays as somehow lowering rates for customers within the postal monopoly, the truth is that monopoly-market customers are in danger of paying *higher* rates.

Taxpayers and competitive-market customers are also at risk. Because the Postal Service confronts quick-moving, determined rivals in competitive markets, unexpectedly large Postal Service losses in those markets are a distinct possibility. One method of making up losses, of

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<sup>60</sup> Derived from data in Postal Rate Commission, "Summary of Revenues and Costs for Major Service Categories, Fiscal Year 2001 - PRC Version (Preliminary)," accessed on the Internet at <http://www.prc.gov/periodic/cra.exe>.

<sup>61</sup> *Ibid.*

<sup>62</sup> See U.S. Postal Rate Commission, "Opinion And Recommended Decision Approving Stipulation And Agreement, Docket No. R2001-1," March 22, 2002, esp. p. 1 of Appendix G and pp. 1-2 of Appendix F, accessed on the Internet at <http://www.prc.gov/docs/33/33578/R2001-1-Decision.pdf>. For a fuller discussion of the disproportionate share of Postal Service costs placed on first-class mail consumers, see Michael Schuyler, "Does First-Class Mail Carry Too Much Overhead?" *IRET Congressional Advisory*, No. 141, November 13, 2002.

course, is demanding more subsidies from competitive-market customers. But if losses are too big for that, taxpayers may have to pick up the tab. As part of the federal government, the Postal Service operates under a de facto federal guarantee. That is why no one expects the Postal Service to declare bankruptcy, even though it has lost money in 20 of the last 30 years and has negative equity.<sup>63</sup> Users of what are now competitive-market products are at risk, too, because a powerful way to strengthen the entity's finances is to enact new monopoly restrictions, if the Postal Service can persuade Congress to go along.

### **What To Do?**

Because the presence of government agencies in competitive markets is harmful rather than beneficial, restrictions on the Postal Service's competitive-market activities are in the public interest. They safeguard consumers within the postal monopoly, taxpayers, the economy's productivity, and even the Postal Service's bottom line. The Presidential Commission and the Congress should not promote the Postal Service's expansion in competitive markets, unless simultaneously the agency is fully privatized by selling it to private-sector investors and ending its numerous governmental powers.

If the Postal Service remains a government entity, it should either be required to leave competitive-product markets or, at the very least, to obey the same rules as other producers within those markets. There is no economic justification for excusing the Postal Service's competitive-market operations from the same government-imposed taxes, fees, and regulations that apply to private-sector businesses in those markets.

For example, on competitive-market products the Postal Service should pay income taxes (if it ever earns money on those products), state and local sales and gross receipts taxes, and state and local property taxes on the properties it owns. (These taxes could be prorated based on the share of Postal Service operations occurring within competitive markets). The Postal Service should pay all applicable vehicle registration fees (again, this could be prorated by the share of Postal Service operations occurring within competitive markets), and it should have to obey the same traffic laws as everyone else. It should be subject to local zoning and land use regulations and subject to the antitrust laws with regard to its behavior in competitive markets.

### **Conclusion**

From its monopoly on the delivery of non-urgent letters, the Postal Service has expanded into a wide range of other mail delivery services and non-mail services. Moreover, it seeks to continue expanding in competitive markets.

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<sup>63</sup> U.S. Postal Service, *Annual Reports*, various issues.

The Postal Service insists that it is motivated by a desire and ability to lower costs and raise productivity if only it becomes bigger. The reality, however, is that the Postal Service's expansion efforts in competitive markets promise few benefits and many risks. The Postal Service's efforts to parley its government mandate to deliver non-urgent letters into a variety of commercial business pursuits would be analogous to the Defense Department saying that since it flies more aircraft than anyone else, it ought to run a commercial airline. It would be like the State Department claiming that it could put its knowledge of other countries to profitable use by running a commercial travel agency. It would be as though the IRS, pointing to its experience collecting tax bills, suggested it could make extra money for the government by doing some private bill collection on the side.

Government organizations in this country do not, for the most part, try to become major producers of competitive-market goods and services. That forbearance is fortunate. Government organizations have a long history of inefficiency and unresponsiveness compared to private-sector businesses. Where production is concentrated in the hands of government, quality, selection, and productivity too often suffer. If the economy's productivity, the well-being of customers within the postal monopoly, and the safety of taxpayers are truly the goals, the Postal Service can best serve the country by leaving competitive markets or, at the minimum, not expanding in them.

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*This is another of a continuing series of IRET papers examining the U.S. Postal Service. IRET began its work in this area in the mid 1990s. Norman Ture, the organization's founder, believed that growth and prosperity are advanced by restricting government to a limited set of core functions. From this perspective he was concerned about the activities of government owned and sponsored businesses. The Postal Service stands out among government businesses because of its size — it employs nearly one third of the federal government workforce — and its persistent efforts to expand, which continue to the present.*

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*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.*