FISCAL ISSUES No. 11

The Anti-Competitive Edge: Government Subsidies To Government Businesses

Case Studies Of The Postal Service, TVA, And Amtrak

By Michael A. Schuyler

Institute for Research on the Economics of Taxation (IRET)

Institute for Research on the Economics of Taxation
1730 K Street, NW • Suite 910 • Washington, D.C. 20006
Phone: (202) 463-1400 • Fax: (202) 463-6199 • Internet: www.iret.org

Table of Contents

The Anti-Competitive Edge: Government Subsidies To Government Businesses

Case Studies Of The Postal Service, TVA, And Amtrak

By Michael A. Schuyler

EXECUTIVE SUMMARY

Government owned or sponsored businesses receive an abundance of government aid. The most visible support is explicit government appropriations. Government assistance also takes other forms that are less obvious but often no less substantial. The major categories of indirect subsidies are:

- tax breaks, such as income tax exemptions, sales tax exemptions, and property tax exemptions;
- regulatory breaks, such as antitrust exemptions, motor vehicle licensing and registration exemptions, and zoning exemptions; and
- government-subsidized interest rates unavailable to ordinary businesses.

Government subsidies to public-sector businesses cause many types of harm. Some of the main problems are:

- subsidies decrease the economy's efficiency and productivity;
- subsidies burden taxpayers and/or users of government services; and
- subsidies are unfair to the owners and employees of private-sector businesses attempting to compete against subsidized government businesses.

This report uses three case studies to provide a better understanding of the magnitude and range of government subsidies, how heavily government enterprises depend on subsidies, and how costly those subsidies are to others. The three case studies are the U.S. Postal Service, which is the federal government's largest business, the Tennessee Valley

Authority, and Amtrak. Estimates prepared for this report put a dollar value on some of the subsidies the government gives its businesses.

A general finding that is fleshed out by the case studies is that government does not belong in business ventures. The incentives the government brings to a business interfere with effective cost control, responsive service, and innovation. This leads to the conclusion that government should minimize its role in business ventures and leave business activities to the private sector whenever possible.

Perversely, though, incentives within public-sector organizations favor expansion, despite the costs. Hard-to-see indirect government subsidies are a useful tool for proponents of expansion because they allow troubled government enterprises to look healthier and better run than the really are.

A second general finding, also reinforced by the case studies, is that government subsidies worsen many of the problems at public-sector businesses because the subsidies give the businesses a financial cushion that further insulates them from the need to be efficient. To promote efficiency and fairness, government owned or associated businesses should be denied government subsidies whenever possible.

The three case studies are summarized below.

U.S. Postal Service

The U.S. Postal Service enjoys a statutory monopoly over first-class and "standard" (formerly third-class) mail delivery. The organization, which is part of the federal government, also operates in competitive markets, where it vies against private-sector businesses. The Postal Service portrays itself as a smoothly run, "self-supporting federal agency", but it insists that to maintain and improve its efficiency, it must expand aggressively in competitive markets.

This report finds that, to the contrary, the government-owned Postal Service is not self-sufficient and does not belong in competitive markets.

The Postal Service should not be operating outside its monopoly. It will tend to underperform private-sector businesses because of the government-based incentives under which it operates. Whereas private-sector companies strive to earn market rates of return, government businesses have the lesser goal of breaking even. And while owners and employees bear the risks if private businesses fail, the risks at public-sector businesses are mainly shifted to taxpayers and captive-market customers.

By leaving competitive markets and concentrating on its core, monopoly markets, the Postal Service would help the overall economy by taking fewer resources away from more efficient private businesses; it would help taxpayers by imposing fewer risks on them; and it would help captive-market customers by insuring that they are not be forced to subsidize the Postal Service's activities in competitive markets. Moreover, by separating itself from competitive markets, the Postal Service would be acting less unfairly towards the owners and employees of private-sector businesses, which must pay taxes and obey regulations that the Postal Service ignores.

The Postal Service disagrees. It argues that it could easily lower its costs and strengthen its bottom line by becoming bigger. However, neither empirical evidence nor economic theory support the Postal Service's contention that it would become more efficient by expanding and becoming more involved in competitive markets. For example, when the General Accounting Office compared costs and revenues on 19 new Postal Service products from inception through fiscal year 1997, it discovered that the Postal Service had lost $85 million on the new products.

Although the Postal Service does not obtain direct federal appropriations (with a minor exception), its claims that it receives no government aid are deceptive because they ignore numerous, valuable implicit government subsidies. Unlike private-sector businesses, the Postal Service never owes federal income taxes, state and local income taxes, state and local sales taxes, or state and local gross receipts taxes; it is exempt from inventory and property taxes on assets it owns; and it pays a low-cost alternative to the unemployment tax. The government also subsidizes the Postal Service by granting it numerous regulatory favors and governmental powers. Some of the most important ones are exemption from motor vehicle licensing and registration requirements, immunity from parking tickets, exemption from local zoning and land use regulations, immunity from antitrust laws, and power of eminent domain. Moreover, the Postal Service's government connection enables it to borrow at a subsidized interest rate. The Postal Service's indirect government subsidies, which are sweeping even compared to those at other government owned or sponsored businesses, hide financial weaknesses at the agency and are a drain on government treasuries at the national, state, and local levels.

This report estimates the magnitude of several of the Postal Service's hidden government subsidies and finds that the total dollar amount may exceed $1 billion annually. The report estimates that, on the Postal Service's operations in 1997, its income tax exemptions gave it a subsidy of approximately $500 million, about $415 million from the federal government and about $75 million from state and local governments. An estimate of the Postal Service's total income tax, sales tax, and property tax subsidies in 1997 is $1.2 billion. Moreover, because these estimates omit some tax and regulatory benefits, they understate the full amount of the government aid. If the Postal Service had lost its subsidies—that is, if it had been treated comparably to other businesses—it likely would have been forced to report a loss in 1997.

The above numbers do not factor in the Postal Service's relative inefficiency compared to private-sector businesses. The Postal Service generated much less income per dollar of revenue and somewhat less income per dollar of assets than did private-sector companies. Suppose the resources used by the Postal Service were redeployed in the private sector and delivered average returns there. Estimates of the income taxes that federal, state, and local governments would have collected from the private businesses range from about $535 million to $2.2 billion, in comparison to income taxes from the Postal Service of zero.

The Postal Service insists that it should not have to subsidize other federal agencies through reduced postage rates; the Postal Service recognizes—when the shoe is on the other foot—that indirect subsidies promote resource misallocation and inefficiency, generate misleading financial reports, and surreptitiously siphon funds from one part of government to another. The same arguments, as well as fairness to the private firms against which the Postal Service competes, indicate that governments should not be subsidizing the Postal Service through tax, regulatory, and other breaks. The Postal Service's government-bestowed advantages should be eliminated wherever possible, either on all its operations or, at a minimum, on its operations outside its first-class mail monopoly. Continuing benefits for first-class mail while treating other Postal Service operations as fully taxable private activities would be similar in concept to the unrelated business income tax (UBIT), which does not tax the core missions of qualified public service organizations but does tax the organizations on their income from ordinary business activities.

A proposal receiving serious attention in Congress would give the Postal Service more flexibility to operate in competitive markets while trying to construct protective fire-walls between its monopoly and competitive activities. Unfortunately, the fire-walls are likely to develop holes that seriously reduce their effectiveness. More fundamentally, the proposal rests on the false premise that the Postal Service needs to expand in competitive markets in order better to serve its monopoly core.

Tennessee Valley Authority

TVA's boast that its "power program costs the taxpayer nothing" disregards the billions of dollars of indirect subsidies that taxpayers have pumped into TVA. The chief type of government subsidy to TVA is low-cost credit. One reason TVA can borrow more cheaply than ordinary businesses is that, as part of the federal government, interest payments on its debt are exempt from state and local income taxes. TVA's borrowing costs are further subsidized because the federal government, although not legally obligated to do so, is widely perceived to back TVA's debt. The *de facto* credit guarantee shifts much of the risk of TVA's investments to the U.S. Treasury and U.S. taxpayers.

Based on TVA's income and balance sheets in 1997, it is estimated that TVA saved about $135 million due to the perceived federal credit guarantee on its debt and another $90 million because its interest payments are exempt from state and local income taxes, for a total annual interest-cost saving of $225 million.

Because TVA can obtain subsidized credit, it tends to accumulate too much scarce capital and be too insensitive to risks. It has far more physical capital per unit of power generation than otherwise comparable investor-owned utilities. When TVA uses production resources less efficiently than private-sector businesses, it imposes an implicit loss on the economy in the form of lost output. Part of this cost is felt at the government level because less output leads to smaller tax bases. If TVA had generated the same pre-income-tax income per dollar of revenue as the average investor-owned electric utility, its income would have been almost $600 million greater than it was, and it would have contributed about $230 million in income taxes to federal, state, and local governments in 1997. If TVA had used its immense capital stock to generate the same pre-income-tax income per dollar of capital as the average investor-owned electric utility, its income would have risen by almost $2 billion, and it would have contributed over $750 million in income taxes in 1997.

Without its government assistance, TVA would be showing red ink, if it operated as it does now. Concerns for the productivity of the economy and the safety of taxpayers urge that the federal government leave the electric utility business. In the meantime, efforts should be made to limit TVA's government subsidies.

Amtrak

At the time of its founding, Amtrak enjoyed an enormous, implicit federal subsidy: the unstated promise that Washington would bail it out should it fail. Because of Amtrak's desperate financial condition, that implicit subsidy soon turned into overt subsidies—over $25 billion of federal aid committed or promised so far. In addition to sending direct government appropriations to Amtrak, governments are losing potential tax dollars. Amtrak receives some hidden government subsidies due to its exemption from many state and local taxes. A bigger loss of potential tax dollars involves reduced output and incomes. If the scarce production resources claimed by Amtrak were used instead by private-sector companies operating at average market efficiency, production and incomes would be higher, and governments would collect a share of the increased economic activity in taxes. A cautious estimate of the income tax loss, which is on top of all explicit subsidies, is about $90 million yearly.

Amtrak provides a striking lesson that although federal guarantees are not always called due, the costs to taxpayers and others who must foot the bills can be high when they are. Amtrak also illustrates how reluctant governments are to admit their mistakes when government-owned or sponsored enterprises fail financially or provide fewer benefits than promised. Governments tend to pump in more taxpayer money and hope for the best. A comparison of Amtrak's ongoing losses and meager benefits suggests that the federal government should long ago have discontinued its subsidies to Amtrak and gotten out of the intercity rail passenger business.

The Anti-Competitive Edge: Government Subsidies To Government Businesses

Case Studies Of The Postal Service, TVA, And Amtrak

Introduction

Government owned or sponsored businesses receive a rich assortment of special government benefits. The aid ranges from explicit government payments, which are fairly visible, to a variety of indirect government subsidies, which are much harder to see even when the amount of aid is substantial. The main types of indirect supports are:

- tax breaks such as income tax exemptions, sales tax exemptions, and property tax exemptions;
- regulatory breaks such as antitrust exemptions, motor vehicle licensing and registration exemptions, and zoning exemptions; and
- government-subsidized interest rates not available to ordinary businesses.

For example, government-associated entities can often borrow, either from private lenders or the government itself, at preferentially low interest rates normally reserved for borrowers with the best credit ratings. Lenders commonly offer government-associated entities—no matter how financially shaky—interest rates that incorporate very low default-risk premiums because the entities' debts are seen as having government backing. When government owned or sponsored entities are heavy borrowers, this can be their largest implicit government subsidy.

A government-supported enterprise like Amtrak, which chronically spills red ink, depends on government checks to stay afloat; it would quickly go broke without large infusions of public money. It receives some indirect government aid, too.

Government owned or sponsored enterprises that operate in the black usually also seek government aid, but prefer that it be in less visible forms. The United States Postal Service, for instance, proudly announces that it receives no taxpayer dollars, but what it really means is that it obtains no government aid in the form of actual appropriations. It happily receives government assistance worth, at minimum, hundreds of millions of dollars yearly through tax exemptions, regulatory privileges, and government-backed credit.

Regardless of the exact forms that government subsidies to its own businesses take, they cause many types of damage. Some of the main problems are:

- subsidies decrease the economy's efficiency and productivity;
- subsidies burden taxpayers and/or users of government services; and
- subsidies are unfair to private-sector businesses attempting to compete against subsidized government businesses.

Subsidies to government-related businesses hurt the economy because they shelter inefficiency. For example, if a government-owned business saves millions of dollars by being exempted from some of the taxes that private-sector businesses must pay, it has that much extra leeway before it feels financial pressure to use its labor and capital inputs efficiently or to respond to customers' needs. Or, if a government-associated business incurs steep losses, government payments may allow it to delay addressing its problems, which permits the difficulties to continue and often worsen. In contrast, if a privately-owned business experiences severe losses, it must take remedial action promptly.

Government aid to businesses it owns or sponsors is also troubling because someone must pay for the government's largesse. For instance, if a government gives one of its businesses a tax exemption worth $500 million, the remaining taxpayers must be taxed that much harder if the government has a fixed revenue target. Alternatively, the government could cut government services by $500 million, which would make beneficiaries of government services pay for the subsidy that the government bestows on its business. Less conspicuously, the government could finance the $500 million subsidy by borrowing or printing money. Whichever method or combination of methods the government chooses, however, it shifts the cost of its subsidies to someone.

Another disturbing property of government subsidies is that they unfairly handicap private-sector businesses attempting to compete against publicly supported ones. Taxes and regulations are major expenses for most private-sector businesses and must be built into the businesses' price structures. Why should government owned or sponsored businesses be able to sell products similar to those of private-sector firms without having to bear similar government-imposed costs? And why should public-sector enterprises be able to borrow at subsidized interest rates while private-sector businesses must normally pay market interest rates? These government-imposed disparities unjustly cut into profits and sales at private-sector businesses, penalizing the businesses' owners and employees.

Indirect subsidies raise a special problem. Because they are mostly concealed from view, they let government-associated enterprises appear stronger than they actually are. Without hidden subsidies, government owned or sponsored enterprises that appear to be profitable would show smaller profits or even losses, and government-associated enterprises already spilling red ink would have to acknowledge bigger deficits. Thus, eliminating covert subsidies to government owned or controlled businesses whenever possible would make the operations of government more open and strip away some of the camouflage that many public-sector businesses now enjoy.

Public-sector entities would face closer scrutiny from voters and legislators regarding their performance if their true bottom lines—without benefit of indirect subsidies—were revealed. A public-sector business that operates in the black and receives only indirect subsidies is apt to boast of how well it performs and compare itself favorably to private businesses, even if it has substantial government subsidies that contribute greatly to its financial results. The appearance of financial soundness provided by indirect subsidies helps public-sector business argue that they deserve to continue or even expand.[1]

This paper uses three case studies to examine government subsidies to government owned or sponsored businesses.[2] In two of the cases, all of the subsidies are indirect. Estimates of the

---

[1] In contrast, if a government owned or sponsored business depends on direct government payments, people can readily see that it is not standing on its own feet. Accordingly, the business is not likely to claim (and would not be believed if it tried) that it operates like a top-notch private-sector business. The visibly subsidized government business is more likely to say that it is trying to improve and that the tasks the government assigns it are handicapping its performance.

[2] The list of public-sector businesses is long. A number of those at the federal-government level are reviewed, each briefly, in a lengthy General Accounting Office (GAO) study. (See General Accounting Office, *Profiles Of Existing Government Corporations*, December 1995.) The GAO study just cited does not include descriptions of government-sponsored enterprises (GSEs), such as Fannie Mae, Freddie Mac, and Sallie Mae, but in written testimony to Congress GAO provides an overview of GSEs. (See General Accounting Office, *GSEs: Recent Trends And Policy*, July 1997.) State and local governments sometimes also own or back businesses, with two examples being state-owned liquor stores and municipal utilities. An examination of some of the economic and legal concerns raised by state- and local-government businesses is: Moshe Schuldinger and Dennis Zimmerman, "Taxing State And Local Government Production: Economic And Legal Perspectives," paper prepared for the National Tax Association Spring Symposium, May 10-11, 1999.

magnitude of those indirect subsidies establish that they are very large.

The first case study is the United States Postal Service. Because the U.S. Postal Service is by far the biggest government-owned business in the United States, it is the case this paper examines in the greatest depth.

The Postal Service proclaims that it "isn't funded by government appropriations"[3] and describes itself as "an independent, self-supporting federal agency within the [government's] executive branch."[4] In tune with this theme, a Postal Service Vice President recently pointed to a newspaper story with the headline "Your Tax Money At Work" (about Postal Service sponsorship of a sporting event) and criticized the headline as "factually incorrect. The operations of the U.S. Postal Service have not been supported by tax dollars since 1982."[5] Another Postal Service Vice President described the agency as "the largest retailer in the U.S." and compared it to McDonald's, but with more locations.[6] While it is generally true that the Postal Service does not receive direct federal appropriations[7], its repeated assertions that it does not rely on government aid are grossly misleading in that they ignore implicit government subsidies. The Postal Service

---

[3] U. S. Postal Service, *1997 Annual Report Of The United States Postal Service* (Washington, DC: U.S. Postal Service, 1998), p. 16.

[4] *Ibid*., p. 67.

[5] Frank P. Brennan, USPS Vice President, Corporate Relations, Letter To The Editor, *Washington Post*, October 7, 1998, p. A20.

[6] Patricia M. Gibert, USPS Vice President, Retail, Letter To The Editor, *Wall Street Journal*, June 25, 1999, p. A19.

[7] An exception is a "revenue foregone" appropriation for certain mail, such as mail for the blind, that Congress requires the Postal Service to carry at no or reduced charge.

collects an array of valuable implicit government subsidies—tax exemptions, regulatory exemptions, and federal credit backing—that may top one billion dollars every year. Thus, the Postal Service may appear to be self-supporting, but it is not. The subsidies are particularly troubling because the Postal Service is trying aggressively to expand in competitive markets, and the subsidies, which are solely based on government favoritism rather than efficiency, are powerful weapons to wield against competitive-market rivals.

The second case is the Tennessee Valley Authority (TVA). The TVA boasts that although it "is a wholly owned U.S. Government corporation," its electric power operations are entirely "self-supporting" and "not subsidized by federal dollars."[8] In making this claim, the TVA, like the Postal Service, is using a narrow definition of government help that counts direct government payments but ignores all cost savings due to tax and regulatory exemptions and to a government-enhanced credit rating. As soon as the implicit subsidies are considered, TVA is found to be highly reliant on government assistance. Because TVA has a massive debt load, its implicit interest-rate subsidy from the federal government is especially important.

The third case is the National Railroad Passenger Corporation (Amtrak). Because Amtrak chronically runs huge losses, most of its government subsidies are in the form of direct payments. It also obtains some implicit subsidies. One lesson Amtrak teaches is that government-associated businesses usually carry federal guarantees against default—even when, as in Amtrak's case, the legislation creating the organization does not actually make the government legally responsible for losses. A related lesson is that government guarantees against default are apt to be extremely costly for taxpayers if they are called due.

---

[8] Tennessee Valley Authority, *1997 Tennessee Valley Authority Annual Report*, (Knoxville, TN: Tennessee Valley Authority, 1997), p. 6.

The U. S. Postal Service

Background

The U.S. Postal Service, which is legally part of the federal government's executive branch, was created from the venerable and notoriously inefficient U.S. Post Office Department by the Postal Reorganization Act of 1970.[9] The Postal Service is an immense organization. With its labor force of 900,000[10], it has more employees than does any private-sector company, and with its 1997 sales of $58.1 billion billion[11], it would rank ninth on the Fortune 500 if it were a free-standing company instead of part of the federal government.[12]

First-class and third-class mail[13] account for approximately 80% of the Postal Service's revenues and are the foundation of its business.[14] The Postal Service's owner—the federal government—has granted it a monopoly on these products by means of federal criminal statutes, known as the private express statutes, that prohibit anyone else from sending or delivering first-

---

9 Public Law 91-375.

10 *1997 Postal Service Annual Report*, p. 64.

11 *Ibid.*, pp. 62-63.

12 See *Ibid.*, pp. 62-63 and *Fortune Magazine*, April 27, 1998.

13 The Postal Service now refers to third-class mail as Standard Mail (A).

14 *1997 Postal Service Annual Report*, pp. 62-63. First-class mail is a much larger revenue source than third-class mail. First-class mail generated 57.5% of Postal Service revenues before appropriations in 1997, compared to 22.1% for third-class mail.

or third-class mail, subject to certain exceptions.[15] Moreover, federal legislation enacted in 1934 buttresses the postal monopoly by prohibiting anyone except the Postal Service from placing items in people's mailboxes, in effect making home and office mailboxes an extension of Postal Service property.[16]

Outside its monopoly core, the Postal Service offers many products that compete with similar services available from private-sector firms. Some of the products the Postal Service is selling in competition with private-sector rivals are overnight delivery, expedited delivery, money orders, package delivery, international package delivery, retail merchandise (scaled back following criticism), pre-paid telephone calling cards, voice and fax "mailboxes" (accessed through the pre-paid telephone calling cards), and a facility that processes bill payments for businesses.[17] In addition to its efforts to expand rapidly in these product lines, the Postal Service is trying to develop many other postal and non-

---

[15] For a discussion of the history of the private express statutes, see William Ty Mayton, "The Mission And Methods Of The Postal Power," in J. Gregory Sidak, ed., *Governing The Postal Service* (Washington, DC: The AEI Press, 1994). Also see J. Gregory Sidak and Daniel F. Spulber, *Protecting Competition From The Postal Monopoly* (Washington, DC: The AEI Press, 1996), pp. 11-38, which describes both the statutory monopoly and the exceptions.

[16] Sidak and Spulber, *Protecting Competition From The Postal Monopoly*.

[17] For more detailed descriptions of the Postal Service's competitive market products, including those discussed in the text, see Michael A. Schuyler, *Wrong Delivery: The Postal Service In Competitive Markets* (Washington, DC: Institute For Research On The Economics Of Taxation, 1998), pp. 5-6 and Michael A. Schuyler, "The Postal Service's Market Grab," paper presented at *Mail @ The Millennium: The Future Of The Private Postal Service*, a Cato Institute Conference, Washington, DC, December 1998. Also see General Accounting Office, *U.S. Postal Service: Development And Inventory Of New Products*, November 1998.

postal products. For example, the Postal Service would like to branch out into Internet-based products, such as a service verifying when e-mail was sent (which the Postal Service calls an "electronic postmark", apparently to suggest an association with traditional postmarks) and a service for the secure electronic transmittal of documents. The Postal Service even hopes the government will give it the sole right to manage a portion of the Internet (the top-level Internet domain ".us") and envisions then charging licensing fees to all who want to use that region of the Internet for commercial purposes.

Although its legislative mandate directs the Postal Service to attempt to break even[18], it ran deficits for most of its history. At the end of 1994, its cumulative deficit since the 1970 reorganization stood at $9 billion.[19] Beginning in 1995, however, the Postal Service has reported net income each year (reducing its cumulative deficit since reorganization to under $4 billion). With its January 1999 rate hike, most of which falls on captive customers within its statutory monopoly, it is attempting to post several more years of positive net income.

The Postal System's financial performance would be considerably weaker, however, if not for a long menu of hidden government subsidies that excuse it from many of the taxes and other costs that private-sector businesses must bear. Unlike private-sector businesses, the Postal Service never owes federal income tax. Nor does it ever owe state and local income taxes. In 1997, for instance, it reported net income of $1.3 billion[20] but had

---

[18] "Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service." (United States Code, Title 39, Chapter 36).

[19] *1997 Postal Service Annual Report*, p. 60.

[20] *Ibid.*, p. 60.

a total income tax bill of *zero*. It is also exempt from all state and local sales, gross receipts, and inventory taxes. For example, a private courier service that delivers an overnight package has to remit as sales tax to state government part of what it collects from the customer, and a card shop has to do the same when it sells someone a greeting card or holiday ornament. But when the Postal Service sells overnight package delivery, a greeting card, or a holiday ornament, the total sales tax it must remit is zero. The Postal Service is also completely exempt, on the properties it owns, from all property taxes.[21] Further, the Postal Service does not pay the unemployment compensation tax as do private-sector businesses, but instead reimburses the government only on unemployment benefits that former employees draw.

The Postal Service's tax breaks are lavish compared to those of many other government owned or sponsored businesses. For instance, the federally owned Tennessee Valley Authority does not pay most taxes, but every year it must send state governments in the region where it operates payments in lieu of taxes equal to 5% of its operating revenues. Fannie Mae, which is a government sponsored enterprise, is exempt from most state and local taxes, but, unlike the Postal Service, it is liable for real property taxes,

---

[21] When the Postal Service leases space from a private owner, the private owner is subject to property tax. The Postal Service sometimes agrees to pay the tax for the landlord as part of the lease agreement. The Postal Service reports that under the lease agreements it has negotiated, it "currently pays state and local property taxes on more than one third of its leased properties." (U.S. Postal Service, *Realty Acquisition And Management*, Postal Service Handbook RE-1, Transmittal Letter 13, August 1996, p. 7-27.) Plant, equipment, and structures the Postal Service owns are never subject to property taxes, however, regardless of where they are located. "As a federal entity, the Postal Service is exempt from the payment of state and local property taxes and special assessments. Postal-owned facilities on leased ground are also exempt...[only] the leased ground may be subject to property taxes..." (U.S. Postal Service, *Realty Acquisition And Management*, p. 7-37.)

and at the federal level it must pay income tax.[22] Its federal income tax contribution to the U.S. Treasury in 1997 exceeded $1.2 billion.[23] The scope of the U.S. Postal Service's tax exemptions are also extraordinary compared to the payments that many other countries expect from their postal services. Canada Post, for example, is subject to the Canadian income tax and is also expected to pay its owner, the Canadian government, a dividend. In 1997/98, Canada Post was hurt by a long strike, but still paid to the Canadian government income tax of $9 million (Canadian) and a dividend of $10 million (Canadian).[24]

The U.S. Postal Service also enjoys special regulatory privileges that reduce its costs. One important dispensation is that the Postal Service does not have to register and license its vehicles with state motor vehicle departments. A corollary is that it is not responsible for paying any state registration and licensing fees on its vehicles. In addition, postal vehicles possess full immunity from parking tickets. Whereas parking tickets are an annoying and significant expense for private-sector delivery companies, the Postal Service has more immunity from ticket writers than do foreign diplomats. Another privilege is that the Postal Service is exempt

---

[22] General Accounting Office, *GSEs: Implications Of Removing State And Local Tax Exemption*, Testimony of Associate Director Thomas J. McCool before the House Committee on the District of Columbia, July 14, 1994.

[23] Fannie Mae, *Fannie Mae Annual Report, 1997*, Note 6 to Financial Statements, reported at Fannie Mae Internet site www.fanniemae.com/-markets/stock/1997/ar/f_note6.html.

[24] Canada Post, "Highlights of 1997-98 Annual Report," reported at Canada Post Internet site www.canadapost.ca/CPC2/corpc/annualrpt/-high97.html.

from local zoning and land use regulations.[25] Although the Postal Service tries to accommodate local concerns as a matter of good community relations[26], the fact that it is not bound by local restrictions gives it powerful leverage in negotiations with local officials. The Postal Service also has the power to acquire property through eminent domain. Again, the Postal Service tries to use its eminent-domain authority sparingly[27], but it gains leverage because it has the power. In addition, antitrust laws, which private-sector businesses must obey, do not apply to the U.S. Postal Service.[28]

A particularly controversial feature of these highly advantageous, implicit government subsidies is that the Postal

---

[25] In a case that combines the Postal Service's land use powers and tax exemptions, it bought land in Derry, New Hampshire that the prior owner had left undeveloped under a New Hampshire program that lowers property taxes on undeveloped land but charges a penalty if it is subsequently developed. After the Postal Service developed the land by building a Post Office on it, the town of Derry, N.H. sought to collect a $51,289 tax penalty. The Postal Service refused to pay the tax bill, citing its exemptions from state and local taxes, fees, and zoning requirements. A Postal Service attorney cited 1819 and 1886 Supreme Court decisions upholding the immunity. (See "Derry Says Post Office Owes It $51,289," Associated Press State & Local Wire, August 16, 1998.)

[26] One Postal Service manual instructs agency staff on use of its authority to override local objections this way: "Do not yield to pressures to give the community authority to approve the plans, but show that the Postal Service wants to work with them [the community authority]..." (U.S. Postal Service, *Realty Acquisition And Management*, p. G-1.)

[27] A Postal manual instructs, "Use eminent domain to acquire rights in real property only when there is no other reasonable alternative." (U.S. Postal Service, *Realty Acquisition And Management*, p. 4-42.)

[28] See Sidak and Spulber, *Protecting Competition From The Postal Monopoly*, p. 1.

Service possesses them in *all* markets where it operates, both monopoly and competitive.

Interestingly, the Postal Service becomes a vigorous *opponent* of exemptions when the shoe is on the other foot and the question is whether other parts of the federal government should be exempted from paying postage. The Postal Service insists that other pars of the federal government pay full price, without exemptions. It alludes to fairness when it describes its no-exemption policy as "Equal Treatment":

> "It is the intent of the USPS to treat its customers equally, whether public or private, and maintain postal rate integrity among all customers. This requires collection of equivalent postage from the Federal Government."[29]

The Postal Service is also aware that exemptions promote inefficiency. It explains that charging federal agencies for the postage they use is needed to "encourage economical mail use and management [by the agencies]."[30] The Postal Service's primary objection to the exemptions of others, though, may be that it thinks it unjust for other federal agencies to deplete Postal Service revenues, and worries that the potential revenue loss would weaken it financially.

> "The USPS concludes that Congress intends government agencies to pay postage equivalent to the full, unsubsidized rates. To conclude otherwise would...disguise the true costs of operating the agency

---

[29] U.S. Postal Service, *Financial Management Manual*, Transmittal Letter 4, June 1, 1983, Section 854.1.

[30] U.S. Postal Service, *Financial Management Manual*, Section 852.

> mail programs and complicate [Postal Service] appropriations procedures."[31]

Dangers of a Government Owned and Subsidized Postal Service

A government-owned Postal Service is economically troubling for several reasons. It can be doubly inefficient: in its monopoly operations, it is free from competition, and in all its operations it is free, as a government enterprise, from the need to earn a profit. In its monopoly business, it is able to overcharge some customers to favor others. In its non-monopoly product lines, it can use its monopoly revenues and its freedom from having to earn profits to undercut competing businesses. It puts taxpayers at risk in case of financial difficulty. It violates the concept of federalism. Moreover, its subsidies, which are often overlooked because they are hidden, heighten all these concerns.

<u>A less productive economy.</u> A basic reason why efficiency is a problem at the Postal Service is that it has different financial goals than do private-sector businesses. Private businesses strive to earn competitive rates of return, while the Postal Service's legislative directive is simply to break even. Because of that difference in objectives, the Postal Service has much less need than private-sector businesses to use valuable labor and capital inputs efficiently in production or to stay on its toes to give customers what they want.

A simplified example indicates that the resulting inefficiency may be substantial. Suppose a private-sector business uses $100 of labor and capital, pays $15 in taxes, and produces $125 of output. That leaves it with a $10 return. Now assume a

---

[31] U.S. Postal Service, *Financial Management Manual*, Section 854.2. To make sure other parts of the government pay the postage due, the Postal Service has procedures for carefully auditing other federal agencies' postal usage. (U.S. Postal Service, *Financial Management Manual*, Section 855.)

government-owned business uses the same $100 of labor and capital and even that (contrary to fact) it pays the same $15 in taxes. Because its target is merely to break even, how much output does it need to produce to be financially content? The answer is $115. Thus, in this example, if government production displaces private-sector production so that the $100 of labor and capital inputs are used by the government-owned business instead of the private business, output will tend to fall by $10 ($115 vs. $125).

The example has so far neglected government subsidies. Subsidies lead to more inefficiency. Suppose that the public-sector entity has exemptions which bring down its tax bill from $15 to $5. Because of these indirect subsidies, the government-owned business can achieve its break-even financial objective by producing an output worth only $105. This is $20 less production than the private-sector business would seek to achieve with the same $100 of inputs. It is $10 less production than the public-sector entity strove for before obtaining its exemption. The effect of the implicit government subsidy (here $10) is that it allows the government-owned business to lower its productivity on a dollar-for-dollar basis.

Due to its break-even objective and its indirect subsidies, the Postal Service is likely to be inefficient in its core, monopoly market. Similarly, it tends to be inefficient in competitive markets. Consequently, if the Postal Service expands in competitive markets, it will tend to drag down the economy's productivity: in expanding, it would be taking labor and capital resources away from private-sector companies that would use the resources more productively.

A possible rejoinder to these concerns is that a government business could pass along to its customers the savings it realizes from subsidies ***if*** the subsidies do not cause the business to become less vigilant in controlling production costs and providing high-quality service. In other words, if subsidies do not erode a government business's discipline, the government business could cut prices to its customers by the amount it saves through subsidies. The subsidies would then not be a total loss to the economy, merely a transfer from the taxpaying population at large to the government business's customers. People would be net winners or losers based on how much tax they paid versus how heavily they used the subsidized services.

But even under these most favorable conditions, subsidies would still cause some economic harm. By exempting subsidized products from charges imposed on other products, governments would make subsidized products appear artificially cheap compared to other products. People would respond to the misleading price signals by overusing subsidized products and underusing non-subsidized products. The result would be a misallocation in the mix of goods and services the economy produces, with an associated loss of economic efficiency.

A further, serious problem with this optimistic scenario is that, as explained above, subsidies ***do*** undercut discipline. Because of the incentives they face and because subsidies give them more room for complacency, government businesses will tend to fritter away the cost savings. Government businesses may squander subsidies by using them as a crutch to compensate for or cover up inefficient production techniques. The worsened production inefficiencies that result reduce the total amount of output the economy generates. Through this route, subsidies become dead-weight losses to society, not transfers to customers. Subsidies may also cause government businesses to become more willing to pay above-market rates for labor and materials; the subsidies let the businesses "afford" to pay more. To the extent government subsidies lead to unusually generous payments for labor and materials, the subsidies are transfers. But the beneficiaries are government employees and suppliers—not customers. Empirical research indicates that above-market wage payments are a serious problem at the Postal Service.[32]

Cross subsidization. Much cross-subsidization occurs within the postal monopoly. For instance, a person sending a first-class letter across town subsidizes a person sending a first-class letter across the country, and customers living in cities subsidize customers living in remote areas with higher delivery costs. These cross-subsidies can be questioned on efficiency and fairness grounds. For example, people do not expect to have the same food prices, housing costs, and transportation expenses regardless of where they live. Why should they expect the same postage rate? Nevertheless, these cross-subsidies are widely recognized and have many defenders.

There is another type of cross-subsidy that has virtually no defenders. The problem is that the Postal Service may charge its monopoly-market customers higher prices in order to sell its competitive-market products below cost. The source of this problem is the interaction between the Postal Service's statutory monopoly and its competitive-market activities.

One of the primary arguments made for having a government-owned Postal Service is that it supposedly facilitates first-class mail service by keeping the first-class postage rate low and uniform across the nation. Perversely, however, the Postal Service's simultaneous presence in competitive markets undercuts that goal

---

[32] USPS workers enjoy a wage premium of 28%, according to a study by Perloff and Wachter. See Jeffrey M. Perloff and Michael L. Wachter, "A Comparative Analysis Of Wage Premiums And Industrial Relations In The British Post Office And The United States Postal Service," in M.A. Crew and P.R. Kleindorfer (eds.), *Competition And Innovation In Postal Services* (Boston: Kluwer Academic Press, 1991). (Cited in Michael A. Crew and Paul R. Kleindorfer, "Privatization Of The United States Postal Service, paper presented at *Mail @ The Millennium: The Future Of The Private Postal Service*, a Cato Institute Conference, Washington, DC, December 1998.)

by providing the agency with an inviting opportunity to charge a *higher* first-class postage rate. The temptation for the Postal Service is to make its monopoly-market customers pay more in order to sell its competitive-market products below cost.

Cross-subsidies from customers within the monopoly to competitive markets are likely to occur because in seeking to break even financially, the Postal Service can aim *ex ante* either to break even in each product line or to deliberately incur losses on some products while collecting offsetting profits on other products. The latter choice is in the interest of postal managers and workers: it will let the Postal Service become bigger, which will deliver to its employees more jobs openings, promotions, and prestige. The products that will tend to lose money are competitive-market products. The Postal Service must offer attractive prices on those products, which limits revenues, and it must provide adequate quality, which raises production costs, because customers can readily switch to similar private-sector products.

Monopoly-market customers, in contrast, cannot buy similar products from private-sector firms because the private express statutes prohibit them from doing so. In effect, the postal monopoly holds them captive. That enables the Postal Service to raise rates on its core, monopoly products without losing much sales volume. Accordingly, the Postal Service can easily make its monopoly-market products into profit centers.

In addition to victimizing first-class mail customers—who, in the eyes of many, are the people the Postal Service primarily exists to serve—such cross-subsidies are inefficient. By raising rates within the statutory monopoly, they cause customers to use first-class mail too sparingly, which is allocatively inefficient. (If third-class mail also provides cross-subsidies, inflated postal rates will discourage its use, too.) Simultaneously, by decreasing rates on Postal Service products in competitive markets to below cost, they persuade customers to overuse those products, which is also allocatively inefficient.

The Postal Service's tax exemptions and regulatory dispensations do not worsen this hazard to captive customers. Indeed, if any of the cost savings are passed on to customers rather than being expended on inefficient production methods and above-market payments for labor and capital, they could hold down the overcharges in the monopoly so the victims do not complain as much.

The surest way to protect monopoly-market customers from this forced cross-subsidization is to remove the Postal Service's means to engage in the practice. That can be accomplished by directing the Postal Service to leave competitive markets: if the Postal Service did not sell competitive-market products, it could not compel its monopoly-market customers to subsidize those products.

Risk to taxpayers. Government-owned businesses should come with the warning label: "May be hazardous to taxpayers." The reason is that when one of these enterprises suffers severe losses, the government usually mounts a bailout. To finance the cost of the bailout, the government is likely to raise taxes, either at that time or in the future. Not all government-owned enterprises need bailouts, of course, but experiences here and abroad have taught that many do. And when that happens the expenses can be very high.[33]

Although the threat of financial failure might seem remote at the Postal Service based on its current income statement, it should be remembered that the old Post Office Department ran chronic deficits and so did the reorganized Postal Service until just a few years ago. The organization has been in the red much longer than it has been in the black. It would be foolhardy to assume that history can never repeat itself.

---

[33] The most spectacular cases in recent American history were the bailouts of the FDIC and the FSLIC in the late 1980s and early 1990s, with costs measured in hundreds of billions of dollars.

The danger of losses would exist if the Postal Service operated only in monopoly markets, but it is greater because the enterprise also participates in competitive markets. In competitive markets, the Postal Service faces smart and motivated private-sector companies that will quickly take advantage of Postal Service miscues in pricing, product selection, quality, and marketing. That reduces the Postal Service's margin for error. The more deeply the Postal Service enters competitive markets, the greater is its exposure—and that of taxpayers.

Because of implicit subsidies, taxpayers are already making a down payment on the Postal Service's risks. If the Postal Service were a normal business, it would have to pay a risk premium when it borrows, to compensate lenders for the possibility that it might not be able to repay its debts. The Postal Service does not pay this risk premium, however. Whenever it borrows, the federal government, which protects the Postal Service from default, implicitly shifts the risk premium to taxpayers.

<u>Unfair to private-sector businesses.</u> Taxes and government regulations are heavy expenses for small and large businesses in the private sector. The power of the Postal Service to avoid many of these taxes and regulations while it competes head-to-head against private businesses is a blatantly unfair advantage. In effect, the Postal Service's implicit subsidies are tax and regulatory discrimination favoring the Postal Service over private-sector producers and their employees, based on the identity of the Postal Service's owner.

To recap, when the Postal Service enters a market in which private-sector businesses are operating, it has the government-bestowed advantages that its owner will be happy with a below-market rate of return (provided the Postal Service does not lose money overall), that it can ignore many tax and regulatory costs which other producers must pay, and that its government backing provides it with ready access to low-cost credit unrelated to the actual riskiness of the Postal Service's operations. These special favors put the people investing in and the people employed by private-sector businesses at a serious disadvantage.

Violation of federalism. The United States has distinct national, state, and local levels of government. For the federal system to function properly, each level of government must be respectful of the responsibilities and prerogatives of the other levels. In the case of the Postal Service, however, the federal government has stripped from state and local governments much of the tax and regulatory authority they normally exercise over business activity. For example, states and localities can require private companies located within their jurisdiction to pay tax on the income they make and the property they own, but cannot collect the same taxes from the Postal Service on its business activities. (Nevertheless, state and local governments must still provide the Postal Service with police protection, fire protection, and other government services.) Similarly, state and local governments can make ordinary businesses register their motor vehicles and obey land use regulations, but they cannot require the Postal Service to register its vehicles nor force the Postal Service to observe local land use regulations.

With first-class mail, the federal preemption is probably a non-issue; most state and local governments would view first-class mail delivery as a traditional federal activity and would not see federally-dictated exemptions relating to first-class mail as intrusions upon their authority.[34] With other products, state and local governments would be much more apt to question why the Postal Service should be exempt from taxes and regulations that private-sector businesses would have to observe if they were the ones producing the products. Under current laws, the Postal Service reduces the powers of state and local governments

[34] Of course, if the Postal Service were ever to be privatized and its tax exemptions rescinded, many state and local governments might view as a bonus the ability to begin taxing the very big business of first-class mail service (sales of over $30 billion throughout the nation).

whenever it engages in business activities that would otherwise be performed by private-sector firms.

There have been numerous complaints at the state and local levels about the ability of the Postal Service to ignore state and local sales taxes when selling retail merchandise. The Oklahoma Legislature, for example, recently passed a resolution criticizing the Postal Service's sales tax exemption.[35] The state resolution asks the U.S. Congress to make the Postal Service start collecting state and local sales taxes on the non-postal products it sells. Further, the resolution asks the Oklahoma Tax Commission to determine how much potential tax revenue the exemption is currently costing governments in the state. Gary Rader, mayor of Weatherford, Oklahoma, who helped mobilize support for the resolution, observes that the city loses money to support its police, highway, and park departments when the Postal Service siphons customers from local businesses. State Representative Randy Beutler, who drafted the resolution, points out that local merchants, as well as state and local governments, have a stake in the matter. "It's really a fairness issue. They [tax-exempt Post Offices] are directly competing with the small retailers."[36]

Postal Service's Defense of its Competitive-Market Operations

The Postal Service would disagree vehemently with the warning that its competitive-market activities threaten its captive-market customers. On the contrary, it claims, it operates and wants to expand in competitive markets largely to *help* customers within its monopoly. The Postal Service's argument is that by becoming larger it can tap substantial, additional economies of scale and scope. Due to those economies, supposedly, its unit costs will fall as its grows, causing all of its products to become more affordable.

---

[35] Susan Parrott, "Mayor Wants To Stamp Out Nontaxed Postal Products," *The Sunday Oklahoman*, May 10, 1998.

[36] Parrott, "Mayor Wants To Stamp Out Nontaxed Postal Products."

The problem with the Postal Service's bigger-is-always-better argument is that it is completely at variance with what is observed elsewhere in the U.S. economy. Even in industries where companies need to be large to capture economies of scale, companies are usually big enough to do so by the time they have reached a size of several billion dollars. If that were not the case, many U.S. industries would have a single giant firm. (The largest firm would have the lowest costs and could readily eliminate its rivals by underpricing them.) In reality, industries with powerful size-based economies usually have several firms able to compete vigorously; the cost savings typically level off once the firms attain a size that is an order of magnitude or so below the size of the already enormous U.S. Postal Service. If one looks at various types of delivery services—the Postal Service is essentially a delivery company—that is the pattern one observes. For instance, several private-sector businesses, not a single giant one, successfully provide overnight delivery on a nation-wide basis. The Postal Service's own behavior in contracting out many tasks to much smaller companies in order to save money demonstrates that often the largest firm does not have the lowest costs.[37]

A variation on the economies of size argument is that the Postal Service's core market is supposedly shrinking and that the agency must either find replacement business in competitive markets or watch its average costs skyrocket. The Postal Service has warned, "[A]s technology and competitors continue to erode first-class mail volume, the USPS must be free to find new ways of generating the revenue it needs to carry out its mandate of

[37] It is true that sometimes two companies decide they have synergies and seek to merge. The post-merger company is, of course, larger than its parents. But another common occurrence is that a single company decides various divisions lack synergies and spin them off into smaller companies. Finding the right way to organize a business is a highly dynamic, complicated process, contrary to the Postal Service's position that bigger is automatically better.

universal mail delivery..."[38] According to former Postmaster General Marvin Runyon, "These growing alternatives [to the Postal Service] are challenging our ability to realize the economies of scale that are so vital to improving productivity and holding postage rates down."[39]

Mr. Runyon's message has been heard and taken seriously by members of Congress. Rep. John M. McHugh (R-NY), Chairman of the House Subcommittee on the Postal Service, credits it with being "probably the single most important factor" in launching H.R. 22, his effort to overhaul the laws regulating and controlling the Postal Service.[40] Rep. Dan Burton (R-IN), who is Chairman of the House Government Reform Committee, which oversees the Postal Subcommittee, ably expressed the danger if Mr. Runyon's prognosis is correct:

> [R]apid changes in communication technology ... don't allow Congress and the Postal Service the luxury of an 'if it ain't broke, don't fix it' attitude... [I]f current trends continue, and there is certainly every reason to believe that they will, the Postal Service will have significantly lower revenues and less first-class mail to deliver... Either

---

[38] United States Postal Service, "Facing The Competition," *Delivering The Future*, Issue 5, at Postal Service internet site http://www.usps.gov/dtf/-5dtfcomp.html.

[39] Marvin Runyon, "Testimony before the Senate Governmental Affairs Committee, Subcommittee On International Security, Proliferation, And Federal Services," November 3, 1997, reported at Postal Service internet site www.usps.gov/news/speeches/97/110397a.htm.

[40] The Honorable John M. McHugh, Chairman of the Subcommittee on the Postal Service, "Opening Statement at H.R. 22 Hearing, Subcommittee on the Postal Service," February 11, 1999, reported at Internet site www.house.gov/reform/postal/hearings/mchopenfeb11.htm.

postage rates will increase dramatically or service will suffer, or both."[41]

The Postal Service's own numbers, however, contradict the falling-volume scenario. Deputy Postmaster General Michael S. Coughlin reports, "Providing mail services is a mature but growing business... We project total mail volume over the next decade will grow 3 to 4 percent a year, with First-Class Mail growing 1 to 2 percent a year."[42] The Postal Service's Five-Year Strategic Plan also anticipates "moderate growth in overall volume."[43] The Postal Service's large investments in plant and equipment provide further evidence that the agency foresees volume growth. In fact, because of increased merchandise deliveries due to rising telephone and Internet shopping, some postal employees want raises to compensate for the added work.[44] With volume rising, not falling, the supposed crisis (i.e., dropping volume leading to higher average costs) simply does not exist.

What is true is that the Postal Service has been growing less rapidly than many private-sector competitors in markets where the

---

[41] The Honorable Dan Burton, Chairman of the House Committee on Government Reform, "Opening Statement at H.R. 22 Hearing, Subcommittee on the Postal Service," February 11, 1999, reported at Internet site www.house.gov/reform/postal/hearings/Burtopestafeb11.htm.

[42] United States Postal Service, *1998 Annual Report of the United States Postal Service*, (Washington, DC: United States Postal Service), p. 32.

[43] United States Postal Service, *United States Postal Service: Five-Year Strategic Plan, FY 1998-2002*, 1997, p. 27, at Postal Service Internet site www.usps.gov/history/five-year-plan/into.html.

[44] Lisa Benavides, "Carriers Ask Raise For Extra Mail Load," *The Tennessean*, June 8, 1999, at Internet site www.tennessean.com/sii/99/06/08-postal08.shtml. Although Postal officials often complain that the Internet is siphoning away business, this is evidence that the Internet can also create business for the Postal Service.

Postal Service is not sheltered from competition. In the Postal Service's words, "While volume has grown ... the Postal Service's shares of several of the market segments of its business ... are declining relative to its competition..."[45] This indicates that many potential customers find a better blend of price, service, and innovation at private-sector firms than at the Postal Service. It does not indicate, however, that the Postal Service is contracting in absolute terms or losing economies of size.[46]

In defense of its economies of size argument, however, the Postal Service would point to cost data it has developed that seem to indicate a huge share of its costs are unrelated to specific products or total volume. The Postal Service claimed that in 1996 fully 37% of its costs ($20.4 billion out of $55.0 billion) were of this character.[47] If sales rose and these so-called institutional costs really stayed unchanged, they could be spread over more output, which would tend to lower unit costs. Thus, the Postal Service's contention that such a major fraction of its total costs are overhead costs, unrelated to specific products or total volume, feeds into its economies-of-size claim. The Postal Rate Commission (PRC), an independent federal agency, and others, though, have long been skeptical of the Postal Service's cost data, contending

---

[45] Postal Service, *Five-Year Strategic Plan*, p. 10.

[46] Even if—conterfactually—the Postal Service were shrinking, that would not demonstrate the presence of diseconomies of size. The Postal Service is so large that it could be much smaller than it is now and still capture virtually all size-based economies.

The assumption that downsizing would necessarily produce spiraling unit costs at the Postal Service is also at variance with the experiences of many private-sector companies that have been forced to downsize. While downsizing was painful in most cases, many companies became more efficient in the process because they searchingly reexamined what they were doing and how they were doing it.

[47] *1997 Postal Service Annual Report*, pp. 21-22.

that the organization grossly exaggerates its overhead costs.[48] The PRC's criticism has prompted the Postal Service over time to somewhat reduce the share of costs it claims are institutional[49], but the Postal Service develops most of the cost data itself, and it continues to insist its fixed costs are a very high share of its total costs.

With regard to cross-subsidies from the monopoly to competitive markets, the Postal Service notes that the independent PRC is charged under federal statute with overseeing postal rates to make sure that one product line does not subsidize another. Unfortunately, the PRC may not be able to prevent cross-subsidization if it receives misleading cost data prepared by the Postal Service. If the Postal Service incorrectly takes costs that should be allocated to competitive-market products and instead lists them as institutional, it can lower the apparent costs of competitive-market products to well below their true costs. It can then accomplish cross-subsidization by setting rates that cover the apparent costs of competitive-market products but fall short of their true costs. Suppose the Postal Service were pursuing this strategy. It would report that a large portion of its costs are institutional—which it does. It would then cover much of these "common" costs with revenues from its monopoly—which it also does. In 1996, first-class mail accounted for 52% of volume but covered 70% of "common" costs, in addition to its own costs.[50, 51]

[48] For a good discussion of the issue, with examples, see Sidak and Spulber, *Protecting Competition from the Postal Monopoly*, pp. 106-124.

[49] In the 1970s, the Postal Service claimed that more than half its costs had no connection whatsoever to its product lineup or postal volume.

[50] *1997 Postal Service Annual Report*, pp. 21-22. First-class mail contributed $14.2 billion to the $20.4 billion of "common" costs.

New products have long been an area of contention, with the Postal Service depicting them as the organization's future and critics charging that the real motivation is expansion and that new products tend to be money losers which are subsidized by other agency products. Critics add that if the Postal Service loses money on new products, it must make up the losses elsewhere; with the Postal Service relying disproportionately on first-class mail, that is where it would obtain the bulk of the cross-subsidies. A General Accounting Office (GAO) report throws light on this disagreement by revealing cost and revenue data on a number of new Postal Service products. The GAO report discloses that in the first three quarters of fiscal year 1998, the Postal Service had either discontinued or was losing money on 15 out of 19 new products which it had publicly announced that it was marketing or developing in fiscal years 1995-1997.[52] On the 19 new products, net losses totalled $85 million through fiscal year 1997.[53] Although the GAO correctly observes that many new products lose money, it would be more reassuring if the Postal Service had a

---

[51](...continued)

[51] Even if the Postal service is computing its common costs accurately, the outsized share of them it is forcing upon first-class mail customers should be disturbing. Supposedly, a core mission of the government-owned Postal Service is to provide reliable first-class mail service at low cost. Loading a disproportionate share of common costs on first-class customers (the charitable interpretation) or making them, as customers of a monopolist, pay costs generated by other postal products (the alternative interpretation) is inconsistent with keeping the price of first-class mail low. No wonder the Postal Service is upset whenever a potential first-class mail customer discovers a non-mail substitute; the agency is using first-class mail customers as cash cows. For that reason, quite aside from any economies-of-size argument, it does not want to lose them.

[52] General Accounting Office, *U.S. Postal Service: Development And Inventory Of New Products*.

[53] *Ibid*., p. 20.

better batting average, especially given the robust economy and the strength of business profits, in general.[54]

The Postal Service would reject the above concerns, insisting that it can be trusted not to take advantage of customers, even where it is a monopolist, because it is part of the government. Postmaster General Henderson recently used this you-can-trust-the-government proposition, in combination with an economies-of-size argument, in describing what he claimed is a dilemma regarding electronic payments. On the one hand, he said, it would be cause for alarm if a single *private* company controlled the entire E-payments market because the company would have too much power over customers. On the other hand, asserted the Postmaster General, a competitive E-payments market would be inefficient because different firms would pursue different technologies. The solution, he suggested, is that the "trusted" federal Postal Service control the market:

> "We think the Postal Service has a role in E-payments. If one *private sector* company owned the platform for E-payments ten years from now, you would have a monopoly model ... where you're forced to use one service. On the other hand, if you don't have one

---

[54] Evidence in the GAO report suggests the Postal Service may tend to be unreasonably optimistic about the prospects of new products. For example, the Postal Service set a 1998 revenue goal of $47.5 million for its Global Package Link (GPL) service, although 1997 revenues had been only $31.5 million. Through the first three quarters of 1998, GPL's actual revenues were just $20.3 million, and the service lost money. (*Ibid.*, p. 47.) As another example, the Postal Service told the GAO that its bill processing facility was handling about 50 million remittances annually and should become profitable if it could reach 60 million. Because the facility is not too far from that volume gaol, the implication is that the bill-processing center just needs a little more volume to become profitable. In fact, however, the facility is nowhere close to profitability. In the first three quarters of 1998, it had revenues of only $2.3 million, compared to expenses of $8.6 million. (*Ibid.*, pp. 33, 43.)

> supplier, then everyone builds his own model, you will have a cellular phone model, suboptimized networks. So we think the answer is our role as a trusted third party... And we're exploring how to facilitate E-payments throughout America as a part of the future of delivering the promise and binding our nation together." [emphasis added][55]

A basic flaw in this argument is that government cannot always be trusted to use its power benignly. History provides abundant evidence that governments sometimes abuse their power and favor one group over another, while economic logic points out that when the interests of those in government diverge from the interests of the citizenry, those in government are strongly tempted to follow their own incentives. Indeed, the danger posed by government power was clearly recognized when the U.S. government was founded. The elaborate division of power between the branches of government was one attempt to mitigate that power. With regard to the Postal Service's own behavior, the disproportionate share of costs borne by first-class mail customers and the organization's losses on new products raise serious questions about how far the citizenry should trust the Postal Service.

As discussed earlier, the Postmaster General's contention that greater firm size, culminating in monopoly, brings cost savings is also flawed: firms above a certain size are usually large enough to capture all significant economies of size. It is particularly ironic that the Postmaster General would select the enormously dynamic and successful wireless communications industry as an example of competition's supposed inefficiency. While it is true that there are some incompatibilities when different firms try distinct technologies and change the technologies over time, that testing of

---

[55] William Henderson, "Remarks at the Opening General Session of the National Postal Forum," San Antonio, Texas, May 17, 1999, at Postal Service Internet site www.usps.gov/news/speeches/99/051799sp.htm.

rival ideas in the marketplace and the willingness to modify products to stay a step ahead of competitors drives innovation, bestowing on customers the rewards of wider choices and improved products. Trading the ferment of innovation for a government-run business that acts as a central planner and imposes on an industry a model comfortable to itself would hurt customers, not help them.

Estimates of the Postal Service's Hidden Government Subsidies

The subsidies the Postal Service receives from federal, state, and local governments through special tax, credit, and regulatory treatment are easily worth hundreds of millions of dollars annually. Nevertheless, because the subsidies are indirect, the financial aid they grant the Postal Service appears nowhere on the organization's books. The value of the concealed subsidies must be estimated to gain a quantitative idea of their magnitude.

This study has estimated the value of the Postal Service's concealed subsidies in several ways. The results are presented below.

In each instance, two estimates are provided. The first number is an estimate of the total government subsidy. It points to the magnitude of government aid to the Postal Service and indicates the extent to which the Postal Service's reported financial performance relies on hidden government support. The second number, which is a scaled down version of the first, excludes first-class mail from the estimate; it calculates the subsidy on the Postal Service's other (i.e., non-first-class-mail) products. This figure is provided for the many people who regard first-class mail delivery as a traditional federal service and would like to see a measure of the subsidy that does not include first-class mail.

<u>Estimates based on actual Postal Service operations.</u> Table 1 shows estimates, based on the Postal Service's operations in 1997, of the value of several of its subsidies: its exemption from federal, state, and local income taxes, its exemption from having to collect

Table 1
Estimates Of Some Of Postal Service's Hidden Government Subsidies, Based On Postal Service's Operations In 1997
(Dollar amounts in millions)

Selected Postal Service Financial Information

Postal Service Net Income	$ 1,264
Operating Revenue	58,133
Net Property	19,374
Debt	5,862
Total Assets	53,138
Percent of Revenues Not Derived from First-Class Mail	42.5%

Table 1a Income Tax Subsidies Alone

	All Operations	Prorated to Exclude First-Class Mail
Federal Income Tax (assume 35% tax rate on net income) *	$416	$177
State and Local Income Taxes (assume 6% tax rate on net income)	76	32
Total Income Taxes	492	209

Table 1b Illustrative Estimates of Sales Tax, Property Tax, and Income Tax Subsidies

	All Operations	Prorated to Exclude First-Class Mail
State and Local Sales Taxes (assume 1% rate on sales)	$581	$247
Local Property Taxes (assume 1% rate on net property)	194	82
Federal Income Tax *	352	150
State and Local Income Taxes **	64	27
Total Income, Sales, and Property Taxes	1,191	506

Table 1c Interest Rate Subsidy

Interest-Payment Cost Saving (assume 0.5% interest rate reduction)	$29

* Federal income tax base adjusted for state and local income tax deductibility.
** State and local income tax base adjusted for deductibility of property taxes.

Source for Postal Service Financial Information: 1997 U.S. Postal Service Annual Report. Calculations explained in text.

state and local sales taxes, its exemption from state and local property taxes, and its interest-rate subsidy. The estimates are static in that they take the Postal Service's actions as given. This is done for simplicity, not realism. If the Postal Service were subject to taxes from which it is now exempt, it would change its behavior. Indeed, the better allocation of resources that would result if the Postal Service lost its artificial cost advantages is one of the main arguments for curtailing its subsidies.

The Postal Service reported net income in 1997 of $1,264 million. If it had been treated like a private-sector company, it would have owed corporate income taxes to the federal government and many of the states in which it does business. The federal income tax rate for large private-sector companies is 35%. State corporate income tax rates vary among states, but a reasonable estimate of the average rate, based on data compiled by the U.S. Census Bureau, is 6%.[56] As shown in Table 1a, income taxes alone would have cost the Postal Service $492 million in 1997: $416 million at the federal level and $76 million at the state and local levels.[57]

---

[56] Assuming the federal corporate income tax rate is 35% and remembering that state and local income taxes are deductible from federal, the combined state and local corporate income tax rate can be deduced from the ratio of federal corporate income taxes to state and local corporate income taxes. The Census Bureau reports that in 1995, federal corporate income tax revenues were $157,004 million while state and local corporate income tax revenues were $31,406 million. (U.S. Bureau Of The Census, *Statistical Abstract Of The United States: 1998* (Government Printing Office: Washington, DC, 1998), Table 500.) This ratio implies (working out the algebra) a combined state and local corporate income tax rate of 6.5%. The text cautiously posits a lower state and local corporate income tax rate of 6%. Thus, if the resulting estimate of the state and local income tax subsidy is in error, it is probably on the low side.

[57] State and local taxes are deducted from the federal tax base when computing federal corporate income tax, making the federal tax base $1,264 million - $76 million = $1,188 million.

Table 1a also shows what the income tax bills would be if the Postal Service were only taxed in proportion to the share of its revenues not derived from first-class mail. (As explained earlier, this second estimate does not count the tax-exemption subsidy on first-class mail.) In 1997, the Postal Service obtained 57.5% of its revenues from first-class mail and 42.5% from other sources. Thus, this proration would only tax the Postal Service on 42.5% of its income. The prorated corporate income tax would be $209 million: $177 million at the federal level and $32 million at the state and local levels.

The Postal Service also benefits because sales to its customers are entirely exempt from normal state and local sales taxes, and the properties it owns are completely exempt from local property taxes. For reasons explained below, it is difficult to estimate the value of these tax exemptions with precision, but it is significant that even cautious estimates reveal heavy tax subsidies. The Postal Service recorded total operating revenues of $58.1 billion in 1997. If it had been treated like a private-sector company, most states and localities would have made it collect sales taxes on some sales to some customers. Because private-sector businesses do not collect sales taxes on all sales and because rules vary widely across jurisdictions, it is not certain what percentage of Postal Service sales would have been subject to sales taxes if the normal rules applied. Perhaps erring on the low side, suppose just one out of five sales would be subject to sales tax if the normal rules applied and suppose the average sales tax rate is 5%.[58] That would

---

[58] Some of the Postal Service's products would certainly be subject to sales tax if the products were sold by other businesses. Private-sector package and express delivery companies, for instance, report that they must remit sales taxes to state and local governments on a portion of their customers' payments. (Although economists often talk of retail sales taxes, many state and local sales taxes also tax a range of inter-business transactions.) On the other hand, advertising is not usually subject to sales tax, suggesting that mailings which are considered advertising would be (continued...)

require the Postal Service to collect sales taxes equal to 1% of revenues and remit those sales taxes to state and local governments.[59]

The Postal Service also reported net property and equipment of $19.4 billion in 1997. If the normal tax rules applied, the Postal Service would have been obliged to pay state and local real and personal property taxes on those holdings. The Postal Service's balance sheet does not provide sufficient information to calculate forgiven property taxes accurately[60], but a plausible assumption is that real and personal property taxes would total 1% of net property value under ordinary rules.[61]

---

[58](...continued)
exempt from sales tax even if the Postal Service were treated like other businesses. In the absence of hard evidence on the correct percentage, the one-in-five number used in the text was chosen because it is modest enough that it is unlikely to exaggerate the portion of sales being exempted due to the Postal Service's special treatment. Further work to better determine the correct ratio would be desirable.

[59] It is assumed that the Postal Service fully passes sales taxes forward to customers and that sales do not fall despite the higher tax-inclusive selling prices. These assumptions, which are made for simplicity rather than realism, will tend to produce too high an estimate of the tax subsidy. On the other hand, that may be counterbalanced if the average sales tax rate would, in reality, be greater than the 1% being assumed.

[60] There are two main problems with the Postal Service's property data for estimation purposes. First, the Postal Service values its property at cost, but many localities base tax assessments on fair market value (or fair market value with adjustments). Second, property tax rates vary so widely from locality to locality that making a precise estimate would require knowing property values on a locality-by-locality basis.

[61] For comparison, a recent survey which covered 50 large cities and the District of Columbia found that the unweighted average tax rate was 1.54% in 1996 on the market value of residential property. (See *Statistical Abstract*
(continued...)

Table 1b shows the estimates of the government subsidies due to the Postal Service's exemptions from income taxes, sales taxes, and property taxes.[62] The figure exceeds $1 billion for 1997. Prorated to exclude first-class mail, the subsidy is still half a billion dollars for the year.

These subsidies may appear small relative to the Postal Service's revenues. The estimate here of income tax, sales tax, and property tax subsidies equals only 2% of the Postal Service's revenues in 1997. The subsidy estimate becomes much more substantial, though, when it is compared to the Postal Service's net income. It equals 94% of the Postal Service's net income in 1997, which means that the Postal Service would have shown virtually no

---

[61](...continued)
of the United States: 1998, Table 521. In each city, the tax rate was computed as the assessment level, i.e., the ratio of assessed value to market value, times the nominal tax rate.) The average property tax rate would have been lower if it had covered the entire nation because tax rates in cities are often higher than rates elsewhere. On the other hand, the tax rate would have been considerably higher if it had been expressed in terms of book value rather than market value. The effective tax rate on business property may be lower than the tax rate on residential property if businesses are more vigilant in challenging assessments than homeowners. Cutting the other way, the rate on business property may higher if local governments are fearful of a backlash from large numbers of homeowners and, therefore, value business property more aggressively than they do residential. Because there are adjustments in both directions, it is not clear that it would be inaccurate to assume an average tax rate of 1.5% on the book value of the Postal Service's property. For the sake of caution, however, a property tax rate of only 1% is assumed in the estimate.

[62] Property taxes are deductible expenses when computing income for federal income tax purposes. In Table 1b, income subject to state and local income taxes becomes $1,264 million - $194 million property taxes = $1,070 million. In computing taxable income for federal income tax purposes, state and local income taxes can also be deducted. Thus, the tax base for federal income tax purposes becomes $1,264 million - $194 million property taxes - $64 million state and local taxes = $1,006 million.

net income in 1997 if not for these hidden subsidies. Further, the Postal Service receives many other indirect subsidies. Several of them are described below. If their values were added to those of the three subsidies which have been estimated, the total would almost surely exceed the Postal Service's net income in 1997. *The conclusion is that if the Postal Service had lost its subsidies—that is, if it had been treated like other businesses—it would have been forced to report a loss in 1997.*

One of those other subsidies is a subtle, but multi-million dollar, advantage the Postal Service enjoys in terms of interest costs. Ordinary borrowers must pay a risk premium to lenders to compensate for the possibility of default. The Postal Service, however, can borrow without paying that risk premium because it shares in the federal government's gilt-edged credit rating. In addition to the perception that Washington would bail it out if default threatened, its debt is backed by the full faith and credit of the federal government. The risk of losses is still there, of course, but the federal government has shifted it to taxpayers and anyone else the government might corral to pay the Postal Service's bills.

This credit umbrella was especially valuable when the Postal Service was habitually losing money and piling up billions of dollars of negative equity. Without its federal credit protection, the Postal Service would have had to borrow at junk-bond rates, which are several percentage points higher than federal-government interest rates. Although the Postal Service's financial condition has greatly improved in the last few years, but it is still borrowing at a lower interest rate than it could if the U.S. Treasury did not stand behind it. In 1997, for example, the interest rate on long-term Treasury securities averaged 0.65 percentage point less than the rate on Aaa corporate bonds and 1.25 percentage point less than the rate on Baa corporate bonds.[63] If the Postal Service's

[63] Council Of Economic Advisers, *Economic Report Of The President, 1999* (Washington, DC: Government Printing Office, 1999), p. 412.

government connection gives it an interest rate saving of just 0.5 percentage point, the interest-rate subsidy it received from the federal government on its $5,862 billion of debt in 1997[64] is $29 million. That very modest estimate, which is in addition to those in Tables 1a and 1b, is shown in Table 1c.[65]

The Postal Service's interest-rate subsidy will decline in magnitude if the Postal Service continues to run surpluses and uses the surpluses to pay down its debt. It will increase, though, if Postal Service debt rises, which could happen if the Postal Service again suffers losses or if it makes expensive investments that require borrowing.

The interest rate subsidy could be eliminated on future borrowings if the federal government desired. One practical way to do it would be to require the Postal Service to go to the government when it wishes to borrow but set its interest rate based on what corporations in the same financial condition must pay in the marketplace when they borrow.[66] For the Postal Service, this

---

[64] *1997 Postal Service Annual Report*, p. 53.

[65] Table 1c does not include a cost to state and local governments stemming from the Postal Service's ability to borrow directly from the federal government through the Federal Financing Bank (FFB). State and local governments collect income taxes on interest payments made to taxable, private-sector lenders, but they cannot collect income taxes on interest payments made to the federal government. In 1997, the Postal Service paid $307 million of interest to the FFB (*Ibid.*, p. 45). If the average state and local income tax rate was 6%, state and local treasuries lost $18 million of potential income tax revenues because the Postal Service had a lender that could not be taxed.

[66] Another technique would be to let the Postal Service borrow in the open credit market, where it would pay a lower interest rate than a private-sector company without federal credit backing, but then make the Postal Service pay a fee to the U.S. Treasury. The fee would be the difference (continued...)

would mean borrowing at an effective interest rate that better reflects true credit costs, including the organization's riskiness.

Although these subsidy estimates are large, they are actually on the low side. They do not include some tax breaks that are clearly advantageous but whose dollar amounts are hard to quantify. They also do not attempt to quantify the Postal Service's valuable regulatory privileges. Consider several examples.

The Postal Service saves—and state and local governments lose—millions of dollars yearly because the Postal Service pays no motor vehicle registration and licensing fees and has immunity from parking tickets. It is possible that some states may also be losing motor-vehicle-fuel taxes when the Postal Service buys fuel for its vehicles.[67] State and local governments will experience another revenue loss in cases where they normally collect taxes on supplies sold to businesses if they cannot collect those same taxes on supplies sold to the U.S. Postal Service.

---

[66](...continued)
between the corporate interest rate and the interest rate the Postal Service had to pay. Thus, the fee would offset the interest rate subsidy. (For instance, if the corporate rate were 6% but the Postal Service were able to borrow at 5.25%, the fee would be 0.75%.) On each loan, this would return to the federal government the market's assessment of the value of the federal government's credit guarantee to the Postal Service.

[67] The extent of this subsidy is uncertain because of wide variations in tax exemption rules from state to state. Some states permit exemptions for federal entities, but many do not. Further, the states with exemptions vary as to the point at which the tax is collected and the procedures for obtaining the exemption. The Postal Service claims it pays all state motor vehicle fuel taxes, but more information on its methods of purchasing fuel would be needed to resolve this question. Thanks are given to Lonette Turner of the International Fuel Tax Association (IFTA) and to Bob Pitcher of the American Trucking Association for their helpfulness and the time they took in carefully explaining some of the complexities of state-to-state variations in fuel-tax exemptions.

Another tax subsidy involves unemployment compensation taxes. Like other parts of the federal government, the Postal Service does not pay unemployment compensation taxes on its employees' wages but only reimburses the Unemployment Trust Fund to the extent former employees draw benefits.[68] For private-sector firms, the tax usually exceeds benefit payouts by a wide margin: at the end of 1997, the Federal Unemployment Trust Fund had a balance of $62.1 billion and that year ran a surplus, excluding interest, of $4.4 billion[69]. Consequently, this special arrangement by which the Postal Service reimburses benefits instead of paying the tax saves it millions of dollars yearly.[70]

---

[68] U.S. Code, Title 5, Chapter 85.

[69] Office Of Management And Budget, *Budget Of The United States Government, Fiscal Year 1999, Analytical Perspectives*, p. 334. The trust fund's multi-billion dollar surplus means that businesses, on average, are being overcharged substantially for unemployment insurance.

[70] Suppose that, if the Postal Service had to pay the tax, it would be overcharged the same average dollar amount per worker that other employers are overcharged. Under that simplifying assumption, the Postal Service saved approximately $30 million in 1997 by reimbursing benefits rather than paying the tax, based on its share of the workforce and the Federal Unemployment Trust Fund's 1997 surplus.

The unemployment tax is to some degree experience rated, meaning that a company's tax rate depends, in part, on its claims history. Because the Postal Service would have relatively low claims if it were in the system, it would have a lower-than-average tax rate. If tax rates were based entirely on experience rating and the overcharge were a given percentage of the tax rate, the Postal Service's overcharge, measured in dollars, would then be lower than average. Pushing in the other direction, though, is the fact that rates rise less steeply than claims. The incompleteness of experience rating forces low-claims firms to subsidize high-claims firms. If the Postal Service had to pay the unemployment tax, that subsidy would increase its overcharge. On net, therefore, it is not clear whether the Postal Service would be overcharged more or less than average if it had to pay the unemployment tax. (In a telephone interview, Rob Pavosevich of the U.S. Department of Labor

(continued...)

As one more example, the Postal Service has benefitted in the international delivery business relative to private-sector U.S. companies because of its governmental status. A GAO report concluded that some countries—the GAO notably mentioned Japan—may be giving Postal Service shipments favorable customs treatment compared to the shipments of private-sector U.S. companies.[71] The Postal Service has also had the inside track, compared to private-sector companies, in making sure its own interests received priority in setting rules for international mail. Until the law was changed in late 1998[72], the Postal Service represented the United States at all international postal meetings. While it no longer has "primary responsibility" for formulating U.S. policy (that goes to the State Department), the Postal Service retains an influential official role at international postal meetings.

<u>Estimates of foregone government revenues.</u> The numbers presented thus far have estimated the size of the Postal Service's government subsidies assuming it operates as it does now. The results are revealing, but a weakness of the approach is that the estimated government subsidy would decrease if the Postal Service's inefficiency worsened. Suppose, for instance, that the

---

[70](...continued)
helpfully provided an overview of experience rating, summarizing recent evidence on whether it is actuarially fair, and furnishing references to two studies for the Department of Labor on experience rating: U.S. Department of Labor, "Experience Rating In Unemployment Insurance: Some Current Issues," Unemployment Insurance, Occasional Paper 89-6, 1989 and Wayne Vroman, "An Analysis Of Unemployment Insurance Experience Rating," Draft Report, December 1996. For an earlier study of experience rating, see Joseph M. Becker, *Unemployment Insurance Financing: An Evaluation* (Washington, DC: American Enterprise Institute, 1981), esp. chapter 4.)

[71] General Accounting Office, *U.S. Postal Service: Competitive Concerns About Global Package Link Service*, June 1998, especially pp. 9-11.

[72] The change is contained in the Omnibus Consolidated Appropriations Bill (H.R. 4328) enacted in 1998.

Postal Service's profit dropped because of new difficulties in using labor and capital effectively, causing its costs to rise relative to its revenues. The resulting drop in profits would reduce the apparent income tax subsidy, and the income tax subsidy is a major component of the total estimated government subsidy. Profits would also fall, with a similar effect on the estimated government subsidy, if the Postal Service gave its employees wage increases unmatched by productivity improvements or, more beneficially for customers, if it lowered postal rates.

A second way of looking at the revenue loss avoids this weakness. It asks this question: how much revenue would federal, state, and local governments collect, compared to current revenue, if production occurred at private-sector businesses instead of at the Postal Service? This approach matters to governments concerned about their finances, to taxpayers, and to those dependent on government services. If diverting production from private-sector businesses to the public-sector Postal Service hurts governments' revenue collections, governments must make up the deficiency by charging remaining taxpayers higher rates then would otherwise be necessary, reducing government services below what could otherwise be afforded, borrowing in credit markets, or printing money.

The Postal Service's operations do have a steep price tag in terms of forgone government revenues. Part of governments' revenue loss is attributable to the special rules that the Postal Service enjoys, neglecting income and productivity differences between it and free-market businesses. This is what was estimated above. But another part is caused by the high costs and relative inefficiency of government-owned enterprises.

Public-sector companies usually have low (or nonexistent) profits compared to private-sector businesses. While some defenders of public-sector companies might argue (or hope) that the poor profits characteristic of government companies indicate they are passing along bargain prices to customers, two more likely explanations have been discussed above. Public-sector companies are apt to require more workers and materials to generate a given amount of output than would private-sector businesses because government enterprises lack the pro-efficiency incentives present in the private sector. That takes scarce labor and capital resources away from other uses. The loss of output is a cost to the public because it means people must make do with fewer goods and services and lower incomes. A fraction of the loss is reflected in government revenues: if production were more efficient and output and incomes higher, governments would have larger tax bases and could collect more taxes (or could meet revenue targets while cutting tax rates). In addition, public-sector companies are likely to pay too much (i.e., above-market prices) for labor and materials, again because they are under less pressure than private companies to worry about costs. This government aid to its employees and suppliers is an income transfer; it shifts purchasing power from society at large to government employees and suppliers. It affects tax collections because it reduces the tax base at the business level. For both these reasons, the estimates of the revenue cost to governments exceed the earlier subsidy estimates.[73]

The steps in estimating the revenue cost to governments are as follows. It is assumed that: 1) the production inputs used by the Postal Service are transferred to private-sector businesses; 2) the private-sector businesses generate the average rate of return

[73] A simplified illustrative example may clarify this approach. Suppose a government-owned business has an income of $100. Assume, also, that a private-sector business would have earned $140 if it had carried out the production, using the same inputs and operating at the average efficiency attained in the marketplace. Thus, the difference in income is $40. This gap reflects both reduced economic output and government aid, in the form of above-market remuneration, to government employees and suppliers. Finally, suppose the tax rate is 35%. Then, the income tax subsidy is $35 based on the government company's actual operations (35% of $100). But the cost to the government in terms of forgone tax revenues is really $49 (35% of $140), if one considers the market return that the production inputs could have earned in the private sector.

Table 2a
Estimates Of Postal Service's Revenue Cost To Governments Due To Income Tax Exemption, Based On Income That Private-Sector Companies With Same Receipts Would Have Generated
(Dollar amounts in millions)

Ratio of Before-Income-Tax Income to Receipts for:	Receipts	Income, Pre-Income Tax	Ratio
All Corporations	$14,539,050	$714,193	4.9%
Corporations with assets of $250 million or more	7,984,203	568,380	7.1%
Transportation and Public Utility Corporations with assets of $250 million or more	867,640	68,670	7.9%
Postal Service	58,331	1,264	2.2%
Percent of Postal Service Revenues Not Derived from First-Class Mail			42.5%

If Postal Service Earned Income on its Receipts in Same Ratio as Average Private-Sector Corporation	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$2,856	$1,214
Federal Income Tax (assume 35% tax rate) *	940	399
State and Local Income Taxes (assume 6% tax rate)	171	73
Total Income Taxes	1,111	472
If Postal Service Earned Income on its Receipts in Same Ratio as Average Private-Sector Corporation with assets of $250 million or more	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$4,138	$1,759
Federal Income Tax (assume 35% tax rate) *	1,362	579
State and Local Income Taxes (assume 6% tax rate)	248	106
Total Income Taxes	1,610	684
If Postal Service Earned Income on its Receipts in Same Ratio as Average Private-Sector Transportation or Public Utility Corporation with assets of $250 million or more	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$4,601	$1,955
Federal Income Tax (assume 35% tax rate) *	1,514	643
State and Local Income Taxes (assume 6% tax rate)	276	117
Total Income Taxes	1,790	761

* Federal income tax base adjusted for state and local income tax deductibility.

Source for Corporation Data: Internal Revenue Service, "Corporation Income Tax Returns, 1995," SOI Bulletin, Summer 1998. Calculations explained in text.

Table 2b
Estimates Of Postal Service's Revenue Cost To Governments Due To Income Tax Exemption, Based On Income That Private-Sector Companies With Same Assets Would Have Generated
(Dollar amounts in millions)

Ratio of Before-Income-Tax Income to Assets for:	Assets	Income, Pre-Income Tax	Ratio
All Corporations	$26,013,689	$714,193	2.7%
Corporations with assets of $250 million or more	21,872,999	568,380	2.6%
Transportation and Public Utility Corporations with assets of $250 million or more	1,733,237	68,670	4.0%
Postal Service	53,138	1,264	2.4%
Percent of Postal Service Revenues Not Derived from First-Class Mail			42.5%

If Postal Service Earned Income on its Assets in Same Ratio as Average Private-Sector Corporation	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$1,459	$620
Federal Income Tax (assume 35% tax rate) *	480	204
State and Local Income Taxes (assume 6% tax rate)	88	37
Total Income Taxes	568	241
If Postal Service Earned Income on its Assets in Same Ratio as Average Private-Sector Corporation with assets of $250 million or more	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$1,381	$587
Federal Income Tax (assume 35% tax rate) *	454	193
State and Local Income Taxes (assume 6% tax rate)	83	35
Total Income Taxes	537	228
If Postal Service Earned Income on its Assets in Same Ratio as Average Private-Sector Transportation or Public Utility Corporation with assets of $250 million or more	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$2,105	$895
Federal Income Tax (assume 35% tax rate) *	693	294
State and Local Income Taxes (assume 6% tax rate)	126	54
Total Income Taxes	819	348

* Federal income tax base adjusted for state and local income tax deductibility.

Source for Corporation Data: Internal Revenue Service, "Corporation Income Tax Returns, 1995," SOI Bulletin, Summer 1998. Calculations explained in text.

achieved in the marketplace; and 3) the private-sector businesses are taxed under standard tax rules.

Several comparisons are made below using corporate income tax data for 1995.[74] The results are presented in Table 2. Take the Postal Service's sales in 1997, and suppose that it had achieved pre-income-tax earnings on those sales in the same ratio as did the average corporation.[75] Also suppose that the Postal Service were subject to normal tax rules. As shown in Table 2a, meeting the average earnings-to-receipts ratio of all private-sector companies would have produced earnings in 1997 of over $2.8 billion and income tax payments (neglecting other taxes) of over $1.1 billion. The total amount of tax revenue that governments are forgoing would be larger, of course, if other taxes were included.[76] The share of the revenue cost for non-first-class products is about $470 million.

The tax data from the IRS divide companies into several size categories, with the largest being assets of $250 million or more. Suppose that the Postal Service had achieved the same earnings-to-receipts ratio as private-sector companies with assets of $250 million or more. Then its earnings on its revenues would have been over $4 billion and its income taxes over $1.6 billion. The IRS data also separates companies into several industrial divisions. The category that may be closest to the Postal Service's delivery business is transportation and public utilities. If the Postal

---

[74] Corporate tax return data for 1995 are used because the 1998 and 1997 data have not yet been released and the 1996 data are only preliminary.

[75] As explained in the previous footnote, the ratios for private-sector companies are computed from 1995 tax return data. Because the U.S. economy was not markedly different in 1997 than in 1995 (both were years of economic expansion), the ratios should be similar in the two years.

[76] Including other taxes would increase the estimated subsidy but decrease the amount due to income taxes. That is because some of the other taxes could be deducted from the income tax base.

Service had realized the same earnings-to-receipts ratio as transportation and public utility companies with assets of $250 million or more, its earnings and tax payments would have been higher still.

Table 2b presents the results if the ratio of assets to pre-income-tax-earnings is used as the benchmark. These results are not as dramatic as the receipts-to-earnings comparisons, but they still point to more income than the Postal Service actually registered. For example, if the Postal Service had achieved the same earnings-to-assets ratio as the average private-sector company, it would have generated earnings of over $1.4 billion in 1997 and would have paid income taxes of almost $570 million. The pro-rated share of this revenue cost for non-first-class products is about $240 million.

Suppose, instead, that the Postal Service had achieved the same earnings-to-assets ratio as private-sector companies with assets of $250 million or more. Then its earnings would have been about $1.4 billion and its income taxes almost $540 million. And if the Postal Service had realized the same earnings-to-receipts ratio as transportation and public utility companies with assets of $250 million or more, its earnings would have been above $2 billion and its income tax payments over $800 million.

The Postal Service frequently compares itself to the largest companies on the Fortune 500 list in terms of revenues, sales growth, and employment. Thus, it is fitting to benchmark the Postal Service's performance against the earnings-to-receipts and earnings-to-assets ratios of the 50 largest companies on the Fortune 500.[77] As shown in Table 3, a company in the Fortune top 50 in

---

[77] The listing is found in *Fortune Magazine*, April 27, 1998. The data on receipts, assets, and pre-income-tax earnings in 1997 are from companies' annual reports and companies' 10-K filings with the Securities and Exchange Commission. Because sufficient data were not available on two of the entries (continued...)

1997 with the same receipts as the Postal Service would, on average, have had pre-income-tax earnings of $5.7 billion. Assuming a federal income tax rate of 35% and state and local income tax rates of 6%, it would have paid over $2.2 billion in income taxes to federal, state, and local governments. When the revenue cost is prorated to exclude first-class-mail, it still exceeds $900 million.

The results using the earnings-to-assets ratio are smaller, but remain large. A company in the Fortune top 50 in 1997 with the same assets as the Postal Service would, on average, have earned a net income of almost $2.3 billion. Assuming a federal income tax rate of 35% and state and local income tax rates of 6%, income taxes on that amount would have been about $880 million. The share of the income tax cost for products other than first-class mail would have been $375 million.

These what-if scenarios are necessarily speculative and display much variation. All of them, however, point to much greater revenue losses for governments than are evident from looking at the subsidies based on the Postal Service's actual performance. Both groups of estimates demonstrate that having a government-owned Postal Service and exempting it from many taxes is an expensive proposition for federal, state, and local governments, even though the Postal Service does not receive explicit government subsidies.

Policy Implications

Some analysts have responded to the Postal Service's failings by urging that the federal government get out of the business of

---

[77](...continued)
in the Fortune listing (State Farm Insurance Cos. and TRII-CREF), the income-to-receipts and income-to-assets ratios discussed in the text are based on 48 of the companies in the Fortune top 50.

Table 3
Estimates Of Postal Service's Revenue Cost To Governments Due To Income Tax Exemption, Based On Income-To-Receipts And Income-To-Assets Ratios Of 50 Largest Companies On Fortune 500
(Dollar amounts in millions)

Selected Financial Information

	Income, Pre-Income Tax	Receipts	Assets	Income-to-Receipts Ratio	Income-to-Assets Ratio
Top 50 Companies on Fortune 500	$210,899	$2,153,996	$4,943,840	9.8%	4.3%
Postal Service	1,264	58,331	53,138	2.2%	2.4%
Percent of Postal Service Revenues Not Derived from First-Class Mail					42.5%

Table 3a If Postal Service Earned Income on its Receipts in Same Ratio as Top 50 Companies on Fortune 500

	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$5,692	$2,419
Federal Income Tax (assume 35% tax rate) *	1,873	796
State and Local Income Taxes (assume 6% tax rate)	342	145
Total Income Taxes	2,214	941

Table 3b If Postal Service Earned Income on its Assets in Same Ratio as Top 50 Companies on Fortune 500

	All Operations	Prorated to Exclude First-Class
Imputed Postal Service Income	$2,267	$963
Federal Income Tax (assume 35% tax rate) *	746	317
State and Local Income Taxes (assume 6% tax rate)	136	58
Total Income Taxes	882	375

* Federal income tax base adjusted for state and local income tax deductibility.

Source for Data on Top 50 Companies on Fortune 500: Company Annual Reports, 10-K filings with SEC, and Fortune Magazine, April 27, 1998. Calculations explained in text.

delivering mail and assorted other products.[78] This study's results could be used to support that position. Privatizing the agency, however, draws strong opposition from those who believe, for one reason or another, that first-class mail service should remain in the hands of the government. With that objection in mind, it is assumed here that the government continues to own the Postal Service and that the Postal Service retains its statutory monopoly, although the monopoly may be trimmed a bit around the edges over time. It is also assumed that no actions will be taken that would compromise the Postal Service's ability to deliver first-class mail or place heavier costs on first-class mail users.

These restrictions do not imply that the Postal Service should remain as it is. Fundamental reform is highly desirable and badly overdue. One key finding is that the huge government-owned Postal Service, with its statutory monopoly, should not also operate in competitive markets. A second major finding is that if the Postal Service continues to operate in competitive markets, it should receive no government subsidies in those markets.

New Postal Service forays into competitive markets should be barred. Moreover, on its existing competitive-market operations, the Postal Service should, at the least, have to pay normal federal, state, and local taxes, have to borrow at a market interest rate, and, to the maximum extent possible, be subject to the same regulatory rules as other businesses. One advantage of these reforms is that they would reduce the Postal Service's cushion for inefficiency. Another advantage is that letting governments collect more revenue from the Postal Service might take a little pressure off other taxpayers. A third benefit is that it would conform better with the spirit of federalism, in that the national government would no longer be forcing state and local governments to help support the

[78] See, for example, *Free The Mail: Ending The Postal Monopoly,* edited by Peter J. Ferrara (Washington, DC: Cato Institute, 1990). Also see Peter Passell, "Competition At Every Turn Has Post Office On The Run," *New York Times,* May 15, 1997, p. D1.

competitive-market activities of a federal entity. Another gain is that it would be fairer to the owners and employees of private-sector firms whose sales the Postal Service is trying to take away in competitive markets.[79] One more benefit is that making the Postal Service pay the same government-imposed costs as private-sector firms would more fully show its true performance in competitive markets. That exposure might speed efforts to remove the Postal Service from competitive markets and increase resistance to its attempts to expand in them.

Lessons from the unrelated business income tax (UBIT). The Postal Service's competitive-market operations are analogous to the unrelated business activities of non-profit organizations. In carrying out their primary missions, non-profit organizations are generally not subject to income taxes. Further, many states and localities exempt them from sales taxes and property taxes. These exemptions are on the whole politically popular and seem based on the notion that because non-profits provide useful services intended to help some or all of society (frequently offering alternatives to similar services from governments), they deserve indirect government support. Some of the types of organizations exempted from the federal income tax, for instance, are those "organized and operated exclusively for religious, charitable, scientific ... or educational purposes," labor [or] agricultural...organizations," "chambers of commerce," and "teachers' retirement fund associations."[80] When exempt organizations operate trades or businesses not related to their primary missions, however, governments often hold that the unrelated businesses are taxable. At the federal level, for instance, "income derived by any [exempt]

[79] The Postal Service would still possess the large advantages that it can earn sub-market returns because its owner only expects it to break even, that its competitive-market activities may obtain some cross-subsidization from the monopoly, and that the government will bail it out if it would otherwise go bankrupt.

[80] Internal Revenue Code, Section 501.

organization from any unrelated trade or business...regularly carried on by it" is treated as so-called unrelated business taxable income and is subject to federal income tax.[81]

The reasoning behind the unrelated business income tax (UBIT) is that if exempt organizations operate commercial businesses, they should not have a powerful government-granted tax edge that would often let them displace other commercial businesses. Such a result would be allocatively inefficient, unfair to the owners and employees of taxable businesses, and a threat to government revenues (especially as non-taxable businesses forced out more and more taxable ones.) Referring to a case in which a university owned a large, commercial company that made and distributed pasta, a member of Congress complained that if the university-owned macaroni company could earn profits without paying tax, "all the noodles produced in this country will be produced by corporations held or created by universities."[82]

The Postal Service product that people would be most likely to regard as a public service would be first-class mail delivery.[83]

---

[81] Internal Revenue Code, Section 512. Section 513 adds, "The term 'unrelated trade or business' means ... any trade or business the conduct of which is not substantially related ... to the exercise or performance by such [exempt] organization of its charitable, educational, or other purpose or function constituting the basis for its exemption..."

[82] Representative Dingell, Revenue Revision Of 1950: Hearings before the House Committee on Ways and Means, 81st Congress, 2nd Session, pp. 579-80, cited in Ellen P. Aprill, "Excluding The Income Of State And Local Governments: The Need For Congressional Action," *Georgia Law Review*, Winter 1992, pp. 421-502. In the pasta-factory case, New York University owned the C. F. Mueller Company.

[83] As indicated previously, this perception may owe much to tradition. In the early days of the nation, it may have seemed more urgent for the government to nurture a means of communicating throughout the new nation

(continued...)

It is much more difficult to view as a public service the organization's other products, such as delivering advertisements and solicitations in competition with newspapers, magazines, television stations, and radio stations; delivering packages in competition with private parcel-delivery companies; delivering overnight documents in competition with private-sector companies providing overnight delivery; selling phone cards in competition with convenience stores, gasoline stations, supermarkets, and other businesses; processing bills for utilities and credit card companies; or selling packaging suppliers in competition with thousands of mostly small merchants.

Using the UBIT as a guide and assuming first-class mail is exempt, it would be appropriate to tax the Postal Service on all its other products. (The UBIT line of reasoning indicates that third-class mail, although it is part of the Postal monopoly, should be taxable.) The potential tax revenues governments could collect from doing this were shown in Tables 1 through 3. (If the Postal Service's financial records are judged to be as reliable as those the IRS demands from taxpayers, the Postal Service could compute, based on its books, its net income on first-class mail and on all other products and pay income tax on only the latter. Otherwise, it could use the administratively feasible method described earlier: compute the share of total revenues not derived from first-class mail, prorate the organization's net income by that ratio, and regard the prorated amount as the organization's non-exempt net income.)

The UBIT applies only to the income tax, but the same treatment should be followed with other taxes and many regulations. For example, the federal government should enforce the antitrust laws on all Postal Service products outside the statutory monopoly; state and local governments should apply the

---

[83](...continued)
because transportation and communications were then slow, hazardous, and expensive. Today, of course, many rapid, inexpensive, and convenient transportation and communications alternatives are readily available.

normal rules regarding sales taxes to all Postal Service products except first-class mail; state and local governments should charge the Postal Service property taxes on a prorated share of the values of its properties; and state governments should assess the Postal Service a prorated share of motor vehicle licensing fees.

Legislative Proposals

Legislation enacted in 1998. Two pieces of legislation that slightly moderate the Postal Service's government-dispensed favors became law in 1998. Through the efforts of Representative Anne Northup (R-KY), the Omnibus Consolidated Appropriations Act (H.R. 4328) contains a provision that places in the hands of the State Department "primary responsibility for formulation, coordination, and oversight of policy" with respect to international postal arrangements. Previously, the Postal Service had this authority, and its private-sector rivals feared the Postal Service took advantage of its official standing to put its own interests first. Because the Postal Service will usually still represent the United States at international postal meetings, however, the potential for abuse has been reduced but not eliminated. A second change is that the Postal Service will now be subject to the same OSHA regulations that private-sector businesses have been required to obey for many years. Before passage of the Postal Employees Safety Enhancement Act (S. 2112), which Senator Mike Enzi (R-WY) sponsored, OSHA could inspect Postal Service facilities but not cite the organization for violations.

Rep. Hunter's bill. Because the Postal Service's presence in competitive markets is inefficient and inequitable, Congress should direct the Postal Service to leave those markets. For several years, Representative Duncan Hunter (R-CA) has urged Congress to take a small step in that direction. His Postal Service Core Business Act of 1999 (H.R. 198) would bar the Postal Service from introducing new non-postal products and require it to discontinue any non-postal products it was not already supplying at the start of 1994. Thus, it would place limits on the Postal Service's activities and expansion plans in the product lines farthest removed from mail delivery.

Attacking hidden subsidies. Legislation to wean the Postal Service from its hidden government subsidies would be highly desirable. Such legislation, if it were introduced, might begin by holding the Postal Service responsible for paying income taxes (both federal income tax and state and local income taxes). It might also tell the Postal Service to take responsibility for paying property taxes. On products that are subject to sales taxes when sold by private-sector companies, the Postal Service should be obliged to collect sales taxes when it sells those products. The Postal Service should lose its special rule with regard to the unemployment compensation tax and pay the tax as do private-sector businesses. It should also begin paying state motor vehicle registration and licensing fees. Outside its statutory monopoly, it should become subject to the antitrust laws. Other special breaks that are identified might be repealed or restricted.

The taxes and fees could apply to all Postal Service products, or, as explained earlier, could be prorated to exempt first-class mail using a clear and administratively feasible rule. (If preferred, the proration could be adjusted so as to exempt products within the postal monopoly and only charge taxes and fees on competitive-market products.) If necessary, the tax exemption could be phased out to provide for a gradual transition.

H.R. 22. The legislative proposal currently receiving the most attention is the Postal Modernization Act of 1999 (H.R. 22). It was approved by the House Subcommittee on the Postal Service in April 1999 and reported to the Committee on Government Reform. This is the latest version of legislation that Representative John M. McHugh (R-NY), the Subcommittee's Chairman, has introduced each year since 1996. H.R. 22 is sympathetic to the Postal Service's contentions that the organization must grow bigger to remain strong and that much of the growth must come from competitive-market products. In trying to help the Postal Service, however, H.R. 22's drafters are also mindful that if the Postal Service were given free rein, it could use its powers unfairly against monopoly-market customers and private-sector businesses.

To meet the demands of the Postal Service, H.R. 22 would grant it much more flexibility to adjust prices and offer new products. The bill would divide the Postal Service's products into three categories. Products for which effective competition is not available would be placed in the noncompetitive category and be subject to the most regulation. Over time the number of products in this category might diminish because H.R. 22 would somewhat narrow the scope of the private express statutes that restrain private firms from competing in the Postal Service's monopoly area. Postal products for which there is effective competition would be put in the competitive category. The Postal Service would have much more discretion than it does now in pricing these products. Nonpostal products would be a third category. The Postal Service could continue selling nonpostal products it had introduced before the start of 1994, but H.R. 22 would require that nonpostal products introduced more recently be handed off to a newly created "private for-profit corporation" that the Postal Service would own.[84] The wholly-owned corporation (which H.R. 22 suggests calling the "USPS Corporation") could use its own judgement regarding pricing. The USPS Corporation would not be restricted to selling nonpostal products but could, for example, also offer

[84] This is reminiscent of Rep. Hunter's bill. The difference is that Rep. Hunter's bill would cleanly remove nonpostal products introduced after the beginning of 1994 from the Postal Service, while H.R. 22 would try to remove nonpostal products from Postal Service control but keep them under Postal Service ownership. H.R. 22's strategy may be unrealistic in that ownership normally leads to a considerable degree of control. More important, allowing the Postal Service to retain ownership has the disadvantage that the products offered by the USPS Corporation may receive hidden government subsidies through that link. These disadvantages are strong arguments against H.R. 22's strategy, especially because it is not clear why the Postal Service needs to retain ownership of nonpostal products in the first place.

competitive-market postal products, buy stock in private companies, and form joint ventures with private companies.

Then, in an effort to prevent the Postal Service and the new USPS Corporation from abusing their enhanced discretion, H.R. 22 would erect financial fire-walls between the noncompetitive and competitive categories, with additional fire-walls within each category. The hope is that the fire-walls would be adequate to protect captive postal customers, private-sector businesses, and taxpayers.

Although H.R. 22 tries very hard to meet the Postal Service's demand for more flexibility regarding rate setting and product offerings while safeguarding those whom the Postal Service could otherwise exploit, its approach, regrettably, is flawed at two levels.

First, at an operational level, the fire-walls may not hold or may not prove workable. Designing secure fire-walls is an extremely difficult legislative challenge; details that seem minor now or are interpreted by the courts differently than expected could quickly tear large holes in the fire-walls. If the fire-walls develop holes, captive-market customers, taxpayers, and private-sector businesses would then be left with fewer protections than they have presently.

Second, and more fundamentally, H.R. 22 is built on the false premise that the Postal Service needs more leeway to expand in competitive markets in order to serve its core, monopoly market at a reasonable cost. In fact, the Postal Service could serve its core customers better if it were to retrench and focus on their needs, without being distracted by competitive-market products.

H.R. 22 would take away some of the Postal Service's hidden subsidies, but leave many others in place. Consider several of its key provisions.

Under H.R. 22, the new USPS Corporation would be bound by the same laws and regulations as private-sector businesses because it would be established as a private for-profit corporation, albeit one wholly owned by the U.S. Postal Service. Thus, the USPS Corporation's activities would be subject to income, property, sales, and other taxes. The Postal Service itself, however, would remain tax exempt on ***all*** its activities. It would not pay taxes on the business it generates through its noncompetitive products, its competitive products, or the nonpostal products it retains.[85] Hence, most of what is now tax exempt would continue to be tax exempt under H.R. 22. If H.R. 22 is revised in the future, it could be much improved by taking the tax rules that apply to private-sector businesses and applying the same rules to Postal Service product lines, with the possible exception of first-class mail.

H.R. 22 would make several regulatory changes affecting the Postal Service. The bill would instruct the Postal Service to comply with antitrust laws outside its statutory monopoly. H.R. 22's legislative language, though, indicates that enforcement would in the hands of the PRC, rather than the more experienced antitrust enforcers at the Justice Department and the Federal Trade Commission. The bill would bar the Postal Service from using sovereign immunity as a shield against suits in some cases. H.R. 22 would also specify that federal and state laws and regulations regarding operating and parking motor vehicles apply to those Postal Service vehicles used "primarily and regularly" for products in the competitive category. But this provision's impact is weakened because a vehicle used more than 50% for noncompetitive products would apparently not be covered, even if its use for competitive products is substantial (up to 50%). Again, H.R. 22 would be a better bill if the applicability of these reforms were broadened to cover more Postal Service activities.

---

[85] This reading of H.R. 22 was confirmed by Robert Taub, Staff Director of the Postal Subcommittee, in response to a question from the author on December 2, 1998.

With regard to credit support from the government, H.R. 22 specifies that obligations of the USPS Corporation would carry no legal federal guarantee. On borrowings by the Postal Service to finance competitive products, H.R. 22 stipulates that the Postal Service could no longer obtain funds from the U.S. Treasury but would have to go to private lenders, that principal and interest on securities issued for this purpose would be subject to applicable state and local taxes, and that the securities would not be formally guaranteed by the federal government. These limitations would reduce the federal credit subsidy, but not eliminate it. Although the federal government would be under no legal requirement to do so, it would almost certainly intervene if the USPS Corporation would otherwise go bankrupt or the Postal Service was about to default on competitive-product securities. The perception that the debts of federally owned or sponsored entities have *de facto* federal credit backing, despite the absence of a formal legal guarantee, is why entities like TVA, Ginnie Mae, and Sallie Mae can borrow at interest rates only slightly above the Treasury rate. Thus, taxpayers would still be at risk in the event of serious losses, and the Postal Service and the USPS Corporation could still obtain reduced-interest-rate financing because of their government connection, giving them an unfair advantage over other businesses.

Tennessee Valley Authority

Background

The Tennessee Valley Authority (TVA), a 100% federally owned enterprise, was created by an act of Congress in 1933 to tame and develop the Tennessee River. One of the chief aims of TVA's creators was to eliminate devastating floods. Another was economic development: to "strengthen the regional economy by supplying low-cost power" throughout the area.[86]

In exhorting Congress to establish TVA, Franklin Roosevelt declared his faith in national planning (i.e., central government direction of production throughout the economy). Describing TVA as "national planning for a complete river watershed," he proclaimed that it would be "a corporation clothed with the power of government but possessed of the flexibility and initiative of a private enterprise..."[87] Disparaging the market system and suggesting that the only good growth is government-controlled growth, he continued, "Many hard lessons have taught us the human waste that results from the lack of planning. Here and there a few wise cities and counties have looked ahead and planned. But our Nation has 'just grown.' It is time to extend [government] planning to a wider field..."[88]

Today, TVA "is the nation's largest [single] power supplier and markets about one-half of the total federal production of

---

[86] *1997 TVA Annual Report*, p. 6.

[87] Franklin D. Roosevelt, April 10, 1933, Cited in Marguerite Owen, *The Tennessee Valley Authority* (New York: Praeger Publishers, 1973), p. 14.

[88] *Ibid.*

electricity..."[89] Despite its roots in flood control and associated hydropower, TVA is now a major, multi-source power company that generates almost 90% of its power output using fossil fuel and nuclear plants.[90] Due to heavy, misguided bets on nuclear power, it has an enormous debt load relative to other electric utilities.

TVA is proud to say that its power system "is not subsidized [any longer] by federal dollars."[91] TVA can state this because, like the Postal Service, it is looking only at explicit payments from Washington. TVA has not received federal appropriations for its power-related activities since 1959.[92] Continuing to look only at

---

[89] Congressional Budget Office, *Should the Federal Government Sell Electricity?*, November 1997, p. 3.

[90] *1997 TVA Annual Report*, p. 1.

[91] *Ibid.*, p. 6.

[92] TVA provides various non-power-related services "associated with managing the Tennessee River and its Tributaries." (*Ibid.*, p. 24) TVA receives federal appropriations for those activities. Its appropriation for non-power-related services in 1997 was $106 million. (*Ibid.*, p. 23). Although Congress passed legislation in 1997 that reduced the appropriation to $70 million for 1998 and specified that it be discontinued thereafter (*Ibid.*), Congress, nevertheless, voted in 1998 to give TVA a $50 million appropriation for 1999 (Tennessee Valley Authority, *Annual Report, 1998: The Powerful Balance* (Knoxville, TN: Tennessee Valley Authority, 1999), p. 24.) TVA argues that its non-power activities are governmental functions, and, therefore, should receive government funds. In its financial records (including its income statement and balance sheet), TVA distinguishes between its power-related activities and what it characterizes as its governmental activities. This study concentrates on TVA's power-related activities. An issue for further research would be whether the distinction TVA makes between its power-related and other activities is appropriate and whether TVA reports it accurately in its financial records.

TVA's non-power-related activities can be viewed as subsidies to people living in the Tennessee Valley: the area's residents are the primary (continued...)

explicit payments from the federal government, TVA declares that it "pays all its [power-related] costs with its own electric power revenues ... TVA's power program costs the taxpayer nothing."[93]

TVA's Subsidies

TVA's statements miss a few key points. If TVA were sold, it would fetch dollars to reduce federal debt and interest outlays. As a private-sector corporation it would probably earn higher profits, and as a private corporation it would pay tax on those profits. TVA's income tax exemption is one of the hidden subsidies it receives as a government-owned entity. A typical private company that generates power would regard TVA's tax-exempt status as an enormous benefit.

To be sure, TVA's tax advantage is partially offset because, as the federally owned business prominently notes, it makes payments in lieu of taxes to state and local governments. Under the legislation that established TVA, these tax-equivalent payments are set at 5% of revenues on TVA's power sales to non-federal agencies.[94] TVA claims that its payments in lieu of taxes "are comparable to state and local taxes, excluding income taxes, of neighboring for-profit utilities."[95] Although private companies might respond that they would be delighted if they could follow

---

[92](...continued)
beneficiaries of programs like Tennessee River flood control but taxpayers throughout the nation pay for the programs. Thus, a reasonable question is whether the federal government should be involved in these programs or whether the states in the area should be undertaking the work (perhaps through a regional compact). That question, though, is beyond the scope of this study.

[93] *1997 TVA Annual Report*, p. 6.

[94] *Ibid.*, p. 31.

[95] *Ibid.*, p. 6.

TVA's lead and forget about sending tax checks to state and local governments, it is still true that TVA's payments in lieu of taxes to state and local governments are substantial.

TVA has another, more subtle tax-related advantage over private companies. Because TVA is part of the federal government, buyers of TVA debt issues do not owe state and local taxes on interest payments from TVA.[96] By virtue of this tax exemption, lenders are willing to accept lower yields on TVA debt issues than they would demand if the interest were fully taxable. The interest-expense savings for TVA are considerable.

In addition, TVA's federal connection gives it another interest-expense saving that, although not related to tax payments, is extremely valuable to TVA but is risky and potentially very costly for U.S. taxpayers. Even though the U.S. Treasury is not legally required to stand behind TVA obligations, it is generally assumed that the federal government would step in, if needed, to prevent a TVA default.[97] Because of the implicit federal guarantee, both Moody's and Standard & Poor's give TVA debt the highest credit rating (Aaa for Moody's and AAA for Standard & Poor's).[98] Privately owned electric utilities, in contrast, are usually rated Aa (the strongest ones financially), A (still strong), or Bbb (somewhat weaker).[99]

---

[96] Generally, interest on Treasury debt and debt of federal agencies is exempt from state and local income taxes.

[97] Washington would worry that if it allowed a TVA default, that might undermine confidence in the entire market for federally-sponsored-enterprise debt and could even cause some destabilization in the market for Treasury securities.

[98] See General Accounting Office, *Tennessee Valley Authority: Financial Problems Raise Questions About Long-Term Viability*, August 1995.

[99] See Moody's Investors Service, *Moody's Credit Survey: Weekly Fixed Income Survey*, February 16, 1998, p. 65.

TVA's credit rating is clearly not based on its own finances. The U.S. General Accounting Office warns, "While no cash-flow crisis exists today, GAO believes that TVA's financial condition threatens its long-term viability..."[100] In other words, "Some form of federal government intervention [read: federal bailout] may be required."[101] The nation's continued economic expansion since GAO issued that caution may have given TVA some extra breathing room. Nevertheless, if credit-rating agencies analyzed TVA as a corporation subject to default risk instead of as a federal government entity, they probably would quickly downgrade its credit rating to Bbb—if not to junk-bond status—due to TVA's very heavy debt service load relative to its revenues. TVA would then have much higher interest service costs.

As its credit rating falls, a borrower must add a larger risk premium to the yield it offers in order to persuade lenders to buy its debt. The default-risk premium compensates lenders for the probability of default multiplied by the loss to lenders if there is a default. The value to TVA of the perceived federal guarantee of its debt—and the cost of the risk shifted to the American public—is the default-risk premium TVA avoids paying because it shares in the federal government's Aaa credit rating instead of the Bbb or lower credit rating it would deserve based on its own finances.

TVA has various other advantages due to its position within the federal government. For example, Congress gave TVA a special gift in 1998. TVA wanted to refinance a $3.2 billion loan from the Federal Financing Bank to take advantage of lower interest rates, but the loan carried a prepayment penalty. In late 1998, Congress tucked a few lines into the Omnibus Consolidated Appropriations Act (H.R. 4328) that retroactively changed the

[100] GAO, *Tennessee Valley Authority: Financial Problems Raise Questions About Long-Term Viability*, p. 4.

[101] *Ibid.*, p. 67.

terms of the loan to exempt TVA from the penalty. Another example is that, like the Postal Service, TVA does not pay the unemployment compensation tax but only reimburses the government for costs if former employees draw unemployment benefits.

As discussed earlier in connection with the Postal Service, some of the subsidies might be a transfer from taxpayers to customers of the federal enterprise, rather than either a net loss to the country or a transfer to TVA's workers and suppliers. But here, again, that rosy view naively assumes the subsidies are not wasted on greater inefficiency and resource misallocation. Evidence indicates the subsidies are wasted. If TVA is passing along to customers its government-bestowed advantages, TVA's electricity rates should be extraordinarily low. TVA's electric rates may have been low in the early years, but now its "retail electricity rates are mixed—some higher and some lower—when compared with the rates of neighboring utilities."[102] This is the outcome that would be expected if TVA has squandered most of its government-based cost advantages on inefficiencies in production or excessive compensation for capital and labor.

Estimates of TVA's Hidden Government Subsidies

Three estimates are derived here. The first is based on TVA's income statement and balance sheet. It shows the value of governmental subsidies to TVA, based on how TVA currently operates. The other two estimates ask how TVA would perform if it operated with the efficiency of a typical private company and paid the taxes such a private company would owe. Although these estimates are more speculative than the first, they provide a better indication of the taxes governments are forgoing because a government-owned enterprise rather than a private business is in the power-generation business.

[102] *Ibid.*, p. 37.

Estimate based on TVA's operations. This calculation uses information from TVA's 1997 income statement and balance sheet to provide an estimate of TVA's government subsidies, assuming TVA operates just as it does now. (A private company might operate quite differently.) Further, the estimate is partial, and thus almost certainly on the low side, because it looks only at TVA's income tax savings and interest-cost savings. For example, although it is not clear if TVA's payments in lieu of taxes really equal what TVA would owe in state and local non-income taxes if not for its tax exemption, this estimate gives TVA the benefit of the doubt.

Despite its tax and debt advantages, TVA is barely breaking even and has almost no net income. For that reason, it would owe little income tax if it became taxable. Assuming that TVA would have a federal tax rate of 35% and combined state and local corporate tax rates of 6% if it were a taxable corporation, its total income tax bill would be only $3 million in 1997.[103]

Its interest-cost subsidies, though, are in the hundreds of millions of dollars annually, as shown in Table 4. One advantage TVA has when it borrows is that it can attract lenders with securities whose interest payments are exempt from state and local taxes. Hence, lenders can charge TVA a lower interest rate than they would require on regular taxable securities and still realize the same after-tax return. A reasonable estimate is that this hidden subsidy saved TVA $90 million in 1997.[104] A second edge TVA

[103] When computing federal income tax, state and local income taxes are assumed to be deductible expenses.

[104] This estimate is performed by taking TVA's interest payments in 1997 and computing how much more interest lenders would have needed in order for them to keep the same after-tax amount if the interest had been subject to state and local taxes. (It is assumed in the estimate that lenders have combined state and local income tax rates of 6%. It is also assumed (continued...)

Table 4
Estimates Of Some Of Tennessee Valley Authority's Hidden Government Subsidies
Based On TVA's Operations In 1997
(Dollar amounts in millions)

Selected TVA Financial Information	
TVA Net Income	$ 8
Interest Expense	2,003
Debt	26,877
Table 4a Income Tax Subsidies Alone	
Federal Income Tax (assume 35% tax rate) *	$2.6
State and Local Income Taxes (assume 6% tax rate)	0.5
Total Income Taxes	3.1
Table 4b Interest Rate Subsidies	
TVA's Interest-Payment Cost Saving due to Exemption of Interest Income from State and Local Income Taxes	$ 90
TVA's Interest-Payment Cost Saving due to Implicit Federal Guarantee of Its Debt (assume 0.5% interest rate reduction)	134
TVA's Total Interest-Payment Cost Saving	225

* Federal income tax base adjusted for state and local income tax deductibility.

Source for TVA Financial Information: 1997 TVA Annual Report. Calculations explained in text.

[104](...continued)
that lenders can claim state and local taxes as itemized deductions for federal income tax purposes and are in the 28% federal tax bracket.)

has in attracting lenders is that its debt is regarded as being almost free of default risk because of a perceived federal guarantee. A low-side estimate of what TVA saved in interest costs because of its enhanced credit rating due to perceived federal backing is about $135 million in 1997.[105] Thus, a modest estimate is that TVA's government connection gave it interest-cost subsidies totalling $225 million in 1997. Without that government support, the added interest charges would swamp TVA's meager net income, and TVA would show significant yearly losses if it continued to operate as it does now.

<u>Estimates of governments' revenue loss.</u> In private markets, competition and the profit motive direct resources towards their most productive uses. In government, the incentives are much different, with political and bureaucratic objectives often outweighing economic considerations. Thus, a reasonable expectation is that government-owned TVA is less efficient than a similar electric utility owned by investors.

An indication of TVA's inefficiency can be found in the large amount of physical capital (plant, property, and equipment) it has relative to its generating capacity. (Other things equal, the fewer units of input needed per unit of output, the better.) When a GAO report compared TVA with 11 neighboring investor-owned utilities, it determined that TVA had more physical capital per unit of generating capacity than all but one of the investor-owned

[105] It is assumed that if not for its link to Washington, TVA would have had to pay a risk premium on each dollar of its debt based on the differential between Aaa debt and Bbb debt. The differential varies over time, but it is often approximately 0.5%. This calculation may understate the subsidy because if TVA's debt were credit rated on its own merits, it might be below Bbb grade, implying a larger risk premium and higher interest costs.

Table 5
Estimates Of TVA's Revenue Cost To Governments Due To Income Tax Exemption, Based On Income-To-Receipts And Income-To-Physical Capital Ratios Of Investor-Owned Electric Utilities Throughout Nation
(Dollar amounts in millions)

Selected Financial Information

	Income, Before Income Tax	Revenues	Physical Capital	Income-to-Revenues Ratio	Income-to-Physical Capital Ratio
Investor-Owned Electric Utilities	$28,026	$264,261	$422,041	10.6%	6.6 %
TVA	8	5,552	29,298	0.1%	0.03%

Table 5a If TVA Earned Income on its Revenues in Same Ratio as Investor-Owned Electric Utilities

Imputed TVA Income	$589
Federal Income Tax (assume 35% tax rate) *	194
State and Local Income Taxes (assume 6% tax rate)	35
Total Income Taxes	229

Table 5b If TVA Earned Income on its Physical Capital in Same Ratio as Investor-Owned Electric Utilities

Imputed TVA Income	$1,946
Federal Income Tax (assume 35% tax rate) *	640
State and Local Income Taxes (assume 6% tax rate)	117
Total Income Taxes	757

* Federal income tax base adjusted for state and local income tax deductibility.

Source for Data on Investor-Owned Electric Utilities: Standard & Poor's, Industry Surveys: Electric Utilities, August 6, 1998. Source for Data on TVA: 1997 TVA Annual Report. Calculations explained in text.

utilities.[106] The 11 investor-owned neighbors had, on average, $0.964 million of property, plant and equipment per megawatt of generating capacity; TVA's capital stock per megawatt of generating capacity was about one-third higher, at $1.283 million.[107]

If government-owned TVA uses resources less efficiently than would a private-sector business, federal, state, and local tax collectors will feel the pinch because inefficiency reduces output and incomes, and that means smaller tax bases. (Quite aside from tax collections, of course, the American public is directly harmed by the decreased output, lower incomes, and diminished living standards that result from inefficiency.)

To obtain a measure of the income taxes forgone at the federal, state, and local levels due to TVA's government ownership, suppose an investor-owned electric utility has the same revenues as TVA. Also suppose that, unlike TVA, the pre-income-tax income it generates per dollar of revenue is identical to that of the average investor-owned electric utility, as reported in a nationwide industry survey.[108] How would this firm's income and taxes have compared to TVA's? The results are shown in Table 5. The income-to-revenues ratio was 10.6% at the average investor-owned electric utility, but an anemic 0.1% at TVA, due to its high cost structure. Average performance would have given the company an income of $589 million on its revenues. If the federal income tax rate is 35% and combined state and local income tax rates are assumed to be 6%, this would have produced an income

---

[106] General Accounting Office, *Federal Electricity Activities: Appendixes to the Federal Government's Net Cost and Potential for Future Losses*, Vol. 2, September 1997, pp. 137-138.

[107] *Ibid.*

[108] Standard & Poor's, *Industry Surveys: Electric Utilities*, August 6, 1998.

tax liability of $229 million in 1997 ($194 million at the federal level and $35 million at the state and local levels). In comparison, TVA's income tax payments totalled $0.[109] By this estimate, governments sacrificed over $225 million of potential income tax revenues in 1997 at government-owned TVA. An added implicit cost for governments, mentioned previously, is their subsidization of TVA's debt, which was estimated to be another $225 million in 1997.

For one more comparison, suppose an investor-owned electric utility has the same dollar amount of physical capital as TVA. But suppose that, in contrast to TVA with its massive capital stock and virtually zero income, it achieves the same before-tax income per dollar of capital stock as the average investor-owned electric utility. With average private-sector performance, the dollar amount of physical capital present at TVA would have produced $1,946 million of income in 1997. Assuming a federal income tax rate of 35% and combined state and local income tax rates of 6%, this estimate indicates governments lost $757 million of potential income tax revenues ($640 million at the federal level and $117 million at the state and local levels) in 1997 because of the physical capital invested in TVA rather than in the private sector. (This estimate exceeds the previous one because TVA's capital stock is enormous relative to its sales.) On top of this, again, are the implicit interest-cost subsidies governments gave to TVA.

Misallocation of Capital

TVA's taxpayer-subsidized credit has made possible a vast misallocation of resources. For example, TVA used its easy access to low-cost loans to mount an extremely ambitious nuclear-power-

---

[109] TVA's PILTs are not counted as income tax equivalents because TVA says they do not make up for income taxes not collected. "[T]hese payments are comparable to state and local taxes, *excluding* income taxes, of neighboring for-profit utilities. [emphasis added]" (*1997 TVA Annual Report*, p. 7.)

plant construction program, and was very slow, compared to private-sector utilities, to curtail its nuclear program in response to mounting regulatory hurdles, soaring construction costs, and increasing environmental concerns.[110] Private utilities moved more quickly because they faced rising risk premiums in credit markets and restive shareholders. TVA's connection to the federal government sheltered it from these concerns: because it is federally owned, TVA does not have angry shareholders when it earns sub-market returns; and because it possesses a *de facto* federal credit guarantee, its credit rating remains AAA regardless of increases in the riskiness of its operations.

Recommendations

To inject market discipline into TVA's operations and reduce the odds of future, hugely costly misallocations of scarce capital and labor resources, the federal government should consider selling TVA.[111] Many private utilities would be interested. Neither theory nor historical evidence support the notion popular nearly 70 years ago when TVA was established that a national government is better at running an electric utility than is the free enterprise system. Although the underlying motivation of privatization is market efficiency, an ancillary benefit is that the asset sale would bring several billion dollars into the federal Treasury.

---

[110] For a discussion of some of the problems TVA has had in its nuclear program, see GAO, *Tennessee Valley Authority: Financial Problems Raise Questions About Long-Term Viability*, chapter 3.

[111] TVA's non-power activities could be spun off and continue to be performed by the government, or they could be done under contract by private companies. Either way, TVA's relatively small non-power activities are not a valid reason to keep the entire organization under federal-government ownership.

A Congressional Budget Office (CBO) study reached similar conclusions. Calling "the federal presence in what is in many ways a private and local function ... an anomaly," it explains that federal power facilities (TVA and the five power marketing administrations of the Department of Energy) tend to be inefficient due to:

> "government failures: behavioral impediments to socially efficient power operations. The managerial structure of the federal power program, for example, makes it hard to operate efficiently. Sources of problems include the divided responsibilities of different agencies and branches of government, the constraints of the Congressional budgeting process, and the lack of independent oversight or significant financial constraints on pricing and investing decisions."[112]

---

[112] CBO, *Should The Federal Government Sell Electricity?*, pp. xii-xiii. Although the CBO study concludes that selling TVA would bolster productivity, it is unsure whether the federal government would realize net budgetary savings. Ironically, it is TVA's huge capital stock and associated debt load relative to its power production that causes the CBO to question the budget savings from privatization. The CBO assumes that if TVA remains government owned, it could set rates that are sufficient to cover all costs of operation, including servicing its debt. In other words, the CBO assumes, first, that TVA's rates are driven by costs, not market conditions and, second, that if market conditions would otherwise push revenues below costs, TVA could rely on government restrictions to force customers to pay above-market rates. The CBO next assumes that potential buyers of TVA would not have the same power to hold customers captive in the emerging competitive market for electric power. Accordingly, the CBO cautions that potential buyers may offer less for TVA than the present value of its revenue stream under government protection, if the buyers believe that market-determined electric power prices will be low in the future. Thus, the CBO says, selling TVA may not improve the federal budget. The CBO admits this result may be too strong because of possibilities it does not consider, such as future mistakes by TVA that lead to government payments. The CBO does not mention, but it should, that its argument points to another reason for selling TVA: to protect TVA's customers from the risk of being forced to pay above-market power rates.

Amtrak

Background

Almost 30 years ago, the federal government created the National Railroad Passenger Corporation (Amtrak) "to provide fast ... modern, efficient, intercity rail passenger service."[113] Private freight railroads had formerly supplied intercity rail passenger service, but they were losing money doing so. The private railroads' losses were especially great because they were tightly regulated by the federal Interstate Commerce Commission (ICC), and the ICC vigorously blocked the private railroads' efforts to scale back or discontinue unprofitable routes.

Amtrak was supposed to be "a two year, federally assisted experiment that would become profitable on its own thereafter."[114] Amtrak's enabling legislation was written as though profitability was just around the corner. It established Amtrak as a "for profit corporation" based in the District of Columbia, and directed Amtrak to "develop the potential of modern rail [passenger] service" by "employing innovative operating and marketing concepts."[115] Consistent with the themes that Amtrak should operate on business-like principles and would quickly show profits following a little federal help, it authorized Amtrak to issue common and preferred stock, and specified that the preferred stock

---

[113] Rail Passenger Service Act Of 1970, Public Law 91-518, Sec. 101.

[114] David Linowes, ed., *Privatization: Toward More Effective Government*, Report Of The President's Commission On Privatization (Washington, DC: Government Printing Office, 1988), p. 168, cited in Ronald D. Utt, "Congress Should Accept Industry Offers To Buy Amtrak," Heritage Foundation Backgrounder, No. 1179, May 1998, p. 2.

[115] Rail Passenger Service Act Of 1970, Public Law 91-518, Sec. 301.

pay a dividend of "not less than 6 per centum per annum."[116] Further underscoring what was supposed to be the new organization's business-like, for-profit character, the act declared that Amtrak "will not be an agency or establishment of the United States Government."[117]

The enabling legislation, however, gave the new corporation various powers and benefits not normally associated with private businesses. Amtrak began life with substantial "contributions" from private railroads[118] and subsidies from the federal government. The act promised it "Federal financial assistance", with grants of $40 million initially[119] and federal loan guarantees that could be issued at the discretion of the Secretary of Transportation.[120] Moreover, "[t]o facilitate the initiation of operations ...[the new corporation could] require a [private] railroad to make immediately available [to Amtrak] tracks and other facilities," with compensation to be set later.[121] Amtrak was further helped on the cost side because its enabling legislation, the Rail Passenger Service Act of 1970, allowed it to operate a less far-flung route structure than private railroads had been forced to provide. Amtrak also initially received a statutory monopoly: unless it approved, no other operator could "conduct intercity rail passenger service over any route over which ... [the new

---

[116] *Ibid.*, Sec. 304.

[117] *Ibid.*, Sec 301.

[118] The private railroads' contributions might more accurately be described as ransom because the companies had to make the payments before the federal government would let them discontinue their own money-losing intercity rail passenger services. See *Ibid.*, Sec. 401.

[119] *Ibid.*, Sec. 101, 601.

[120] *Ibid.*, Sec. 602.

[121] *Ibid.*, Sec. 402.

corporation] is performing scheduled intercity rail passenger service..."[122] The fact that the act authorized the President to appoint the majority of Amtrak's board of directors, subject to Senate confirmation[123], underscored both Amtrak's ties to the federal government and the artificiality of its "private" status.

Notwithstanding the reassuring talk of speedy profitability, Amtrak has consistently rung up losses of a magnitude that would have quickly bankrupted a truly private company. In fiscal year 1997, Amtrak's net loss was $762 million, and throughout the last decade, its yearly loss has always been at least $650 million.[124] In its Strategic Business Plan for fiscal years 1999-2002, Amtrak projects that its loss will widen to $930 million in fiscal year 1999 and that, despite efforts to boost revenues and control costs, it will lose $752 million in fiscal year 2002.[125] The GAO observes, "Amtrak spends almost $2 for every dollar of revenue it earns in providing intercity passenger rail service."[126] Only Amtrak's

[122] *Ibid.*, Sec. 401. For examples of how Amtrak used this monopoly power on occasion either to block entry or demand fees from businesses seeking to initiate passenger railroads, see Joseph Vranich, *Derailed: What Went Wrong And What To Do About America's Passenger Trains* (New York: St. Martins Press, 1997), pp. 28-31. Amtrak finally lost this monopoly power, for the most part, under the terms of the Amtrak Reform And Accountability Act Of 1997. (See Stephen J. Thompson, "Amtrak Reform And Accountability Act Of 1997: Selected Provisions And Later Developments," Congressional Research Service, Report For Congress, Updated July 1998.)

[123] Rail Passenger Service Act Of 1970, Public Law 91-518, Sec. 301.

[124] *National Rail Passenger Corporation (Amtrak) Annual Report, 1997*, Statistical Appendix, p. I.

[125] Amtrak, *Amtrak Strategic Business Plan, FY 1999-2002*, October 1998, at Amtrak Internet Site www.amtrak.com/news/pr/plan3.html.

[126] U.S. General Accounting Office, *Intercity Passenger Rail: Financial Performance Of Amtrak's Routes*, May 1998, p. 2.

Metroliner Service "is profitable; all of Amtrak's other 39 routes operate at a loss,"[127] with the loss on those 39 routes averaging "$53 for each passenger."[128] Alarmingly, the GAO finds, "Amtrak's financial condition has continued to deteriorate....[It] continues to lose more money than it planned."[129]

Amtrak's Subsidies

While these losses would have forced a private-sector business to make hard choices long ago, Amtrak has been content to coast along with only modest, incremental changes in its operations. For a generation, an ongoing, multi-billion dollar federal bailout, ultimately financed by U.S. taxpayers, has kept this government-created organization afloat. The GAO calculates, "Through fiscal year 1998, the federal government has provided Amtrak with over $20 billion in operating and capital subsidies..."[130] That figure does not count $2.2 billion going to Amtrak courtesy of the Taxpayer Relief Act of 1997 (TRA-97)[131] and excludes most of an additional $5.2 billion appropriated over the period 1998-2002 by the Amtrak Reform And Accountability Act Of 1997.[132]

---

[127] *Ibid.*, p. 2.

[128] General Accounting Office, "Intercity Passenger Rail: Outlook For Improving Amtrak's Financial Health," Testimony before the U.S. Senate Subcommittee on Transportation, March 24, 1998, p. 7. (On the sole route that does not lose money, Metroliner Service, the profit is $5 per passenger. See *Ibid.*, p. 6.)

[129] *Ibid.*, pp. 3, 6.

[130] *Ibid.*, p. 2.

[131] *Ibid*., p. 2.

[132] Stephen J. Thompson, "Amtrak: Background And Selected Public Policy Issues," Congressional Research Service, Updated November 12, 1998.

TRA-97, in which the Congress slipped Amtrak a hidden, extra $2.2 billion subsidy, reveals a painful contrast between how Washington treats government-supported Amtrak and how it deals with ordinary taxpayers. The income tax code allows companies that suffer losses to carry the losses back to prior years, offsetting income in those prior years and obtaining refunds against the taxes paid then.[133] The carryback period, though, is very short. Prior to the TRA-97, it was 3 years, but TRA-97 reduced the maximum carryback period to 2 years as a revenue raiser.[134] Simultaneously, however, TRA-97 included a special carryback rule for Amtrak: it authorized Amtrak to claim a $2.2 billion carryback refund against the income taxes paid by the *private* railroads that were its precursors *over a generation ago*.[135] Without the special Amtrak provision, TRA-97 would have had no need for the revenues afforded by shortening everyone else's carryback period.[136] In effect, then, thousands of businesses throughout the economy that experience losses are saddled with a tax increase in order to subsidize Amtrak.

---

[133] The reason for allowing the income averaging provided by carrybacks is that income over several years gives a truer picture of a company's profitability than income in a single year.

[134] This means that if a company has losses in the current year and the prior two years, but it earned income and paid income tax three years earlier, it can no longer claim a carryback and income tax refund. (See IRS Code, Sec. 172(b).) Before the law was changed in 1997, the company could have used the carryback. (The company is allowed to carry the loss forward, in the event it earns income in future years.)

[135] See TRA-97 (Public Law 105-34), Act Sec. 977. The actual payment to Amtrak is $2.3 billion,, spread over 1998 and 1999, but Amtrak must pay a portion of this to several states, leaving it with $2.2 billion.

[136] Congress's Joint Committee on Taxation estimated the carryback-limitation provision would collect $1.8 billion over the period 1997-2002. See Joint Committee on Taxation, "Estimated Budget Effects Of An Amendment In The Nature Of A Substitute To The Chairman's Mark Relating To Revenue Reconciliation Provisions," June 11, 1997.

While Amtrak's President talks about continuing the "momentum" towards "making money and building the best railroad anywhere,"[137] the GAO foresees no end to the dependency, "As currently structured, Amtrak will continue to require federal capital and operating support in 2002 and well into the future."[138] Although the Amtrak Reform And Accountability Act Of 1997 grants Amtrak more authority to trim or discontinue money-losing routes, gives it more labor flexibility, and limits its liability in the event of accidents, rail officials and government accountants do not expect significant near-term cost savings from those reforms.[139]

Amtrak agrees that the red ink will keep flowing and seeks greater federal aid. It admonishes Congress that it must have "adequate capital funding"[140], and it complains that Congress has "underfunded" its operating costs in several recent years by sending it too few taxpayer dollars.[141] Amtrak warns that achieving its "goals depends heavily on Congress living up to the [financial] commitments it [Congress] made..."[142] Amtrak also desires a

---

[137] Amtrak, "Amtrak's President Testifies That The Corporation's Business Turnaround Continues," Amtrak News Release, March 4, 1999, at Amtrak Internet site www.amtrak.com/news/pr/atk9934.html.

[138] GAO, *Intercity Passenger Rail: Financial Performance Of Amtrak's Routes*, pp. 2-3.

[139] The reforms may be of some benefit in the long term. See *Ibid.*, pp. 3, 21-23.

[140] *1997 Amtrak Annual Report*, p. 3.

[141] *Ibid.*, p. 23.

[142] Amtrak, "Amtrak Board Approves Landmark Business Plan To Revitalize National Passenger Rail For The 21st Century," Press Release, October 1998.

"dedicated capital funding source"[143], that is, automatic funding which does not go through the annual appropriations process; for that purpose, Amtrak has tried to take a share of the federal gasoline tax paid by motorists. In addition, Amtrak has sought payments from the states, receiving $70 million from that source in fiscal year 1997.[144]

Rather than ceasing to lose money, Amtrak has adopted "operating self-sufficiency" as its financial goal. By that, Amtrak means covering only its operating costs and perpetually depending on government aid to pay its capital costs.[145]

Amtrak also enjoys government favors that are less visible. While this study does not quantify Amtrak's various indirect subsidies, they are substantial, although smaller than Amtrak's explicit subsidies. One advantage, touched on earlier, is Amtrak's power to force freight railroads to let Amtrak use their tracks and other facilities when it provides rail passenger service.[146] This federally granted authority is especially valuable to Amtrak because

---

[143] *1997 Amtrak Annual Report*, p. 23.

[144] GAO, *Intercity Passenger Rail: Financial Performance Of Amtrak's Routes*, p. 11.

[145] Further, Amtrak defines operating costs to exclude certain labor costs: payments to the railroad retirement account that Amtrak contends are excessive. Excluding these employee-benefit payments from its definition of operating costs, Amtrak claims it will exactly reach operating-cost self-sufficiency in 2002, based on its projection in its current strategic business plan. Without that exclusion, it would fall short by $185 million for the year. The annual loss would be hundreds of millions of dollars greater if Amtrak included its capital costs. (See *Amtrak Strategic Business Plan, FY 1999-2002*.)

[146] United States Code, Title 49, Chapter 243.

it owns only about 3% of the tracks over which it operates.[147] Making the power even more valuable, federal law gives Amtrak priority over freight railroads when Amtrak uses the tracks of the freight railroads.[148] One study estimated that the costs to the freight railroads of the resulting delays, for which Amtrak is not billed, are several million dollars annually.[149]

Another hidden subsidy is Amtrak's exemption under federal law from most state and local taxes.[150] Given that Amtrak receives subsidies from a number of states, it is not clear to what extent state and local governments would choose to tax Amtrak, but federal law would block most of their efforts if they tried.

Federal law also grants Amtrak power of eminent domain.[151] Eminent domain is usually regarded as a prerogative of governments and government entities.

Because Amtrak is a "for profit" corporation, it is not exempt from the corporate income tax. Amtrak avoids that tax, however, because it has never earned a profit and never expects to do so. (The massive government payments it receives are not taxable.)

Further, consider how much governments might obtain in additional tax revenue if the resources now going into Amtrak were instead directed by the free enterprise system into their most productive uses. For instance, Amtrak had total assets of

---

[147] General Accounting Office, *Intercity Passenger Rail: Issues Associated With A Possible Amtrak Liquidation*, March 1998, p. 6.

[148] United States Code, Title 49, Chapter 243.

[149] See Vranich, *Derailed: What Went Wrong And What To Do About America's Passenger Trains*, pp. 147-148.

[150] United States Code, Title 49, Chapter 243.

[151] *Ibid.*

$5.7 billion at the end of fiscal year 1997.[152] If those assets had been in a true private-sector business, a reasonable assumption is that investors would have demanded a market rate of return. Suppose they achieved the same ratio of before-tax income to assets as the average private-sector transportation or public utility company with assets of $250 million or more.[153] The ratio in this category was 4%. A 4% return on $5.7 billion of capital is $227 million yearly. With a federal corporate income tax rate of 35% and assuming the state and local corporate income tax rate is 6%, the federal government would collect $74 million of additional income taxes annually and states and localities would collect an additional $14 million, for a total of $88 million.[154] State and local revenues would probably be higher than this (and the federal share somewhat lower) because states and localities normally impose a variety of other taxes. In addition, the company's shareholders would have an added $140 million or so of after-tax income in their pockets.[155]

---

[152] *1997 Amtrak Annual Report*, p. 34.

[153] The ratio of before-tax income to assets for companies in this category is based on tax return data and was presented earlier in the analysis of the Postal Service. The category is relevant to Amtrak because, in the IRS's breakdown of tax return data by industry grouping and asset class, it is the category that most closely matches Amtrak's specifications.

[154] State and local taxes are deductible expenses for federal income tax purposes, causing the federal tax base in this illustration to be $214 million, which is then taxed at a 35% rate.

[155] That the foregone revenues from a government-supported rail system can be considerable was demonstrated in Japan. One study reports that before the Japanese National Railroad (JNR) began the privatization process in the late 1980s, it needed billions of dollars annually in government aid. As it prepared for privatization, market-driven improvements turned around the situation. "[B]y 1991 the combined components of the JNR paid over $3 billion to the government in taxes and other contributions." (See Utt, "Congress Should Accept Industry Offers To Buy Amtrak," p. 9.)

What Should Be Done?

Up to now, the federal government and some state governments have been willing to subsidize Amtrak heavily, often accompanying the subsidies with reassurances that Amtrak only needed a little temporary aid before becoming self-supporting. It is now evident and widely admitted that Amtrak in its present form can never be self-supporting. Further, doubts are increasingly being raised about Amtrak's alleged benefits, with many of the negative findings coming from within the government.

For instance, a key government rationale for supporting Amtrak is to reduce transportation congestion.[156] In fact, however, Amtrak's intercity passenger service has such a small share of ridership—three out of one thousand—that its effect on congestion is negligible.[157, 158] For every Amtrak intercity rail passenger, roughly 270 people go by car, 55 people take a commercial airline, and 4 go by intercity bus. Even private aviation beats Amtrak, carrying twice as much intercity travel. A likely reason why ridership is so low is that, despite Amtrak's promises of speedy transportation, delays are common and

[156] See U.S. Code, Title 49, Chapter 241.

[157] Stephen J. Thompson, "Amtrak and The 105th Congress," Congressional Research Service, Issue Brief For Congress, Updated February 1998, cited in Utt, "Congress Should Accept Industry Offers To Buy Amtrak," p. 3.

[158] This number and those that follow it in the text refer to Amtrak's intercity rail passenger service. In fiscal year 1997, Amtrak provided about 20 million intercity rail passenger trips. In addition, Amtrak operates under contract the passenger services of several commuter railroads; these contract operations carried about 49 million passengers in 1997. (See *1997 Amtrak Annual Report*, p. III.) The commuter railroads could continue their operations without Amtrak by finding other operators or operating their systems themselves.

Amtrak's posted times on many routes are actually slower than the times private railroads achieved on similar routes 50 years ago.[159]

Another supposed gain from Amtrak is energy conservation and pollution reduction.[160] The reality, though, is that while Amtrak is more fuel efficient than aviation, it is not substantially more fuel efficient than automobiles traveling over 75 miles, and almost three times *less* fuel efficient than intercity buses.[161]

As for the frequently heard statement that all forms of transportation are heavily subsidized, a government study finds instead: automobiles and intercity buses pay all their operating, equipment, and right-of-way costs; airlines pay all their operating and equipment costs and about 75% of their right-of-way costs; but Amtrak only pays 50-65% of its operating costs, *none* of its equipment costs, and *none* of its right-of-way costs.[162]

One more rationale for Amtrak's subsidies is that they supposedly benefit its customers. Studies of mass transit, however, indicate that "as much as 75 percent of Federal spending ... ends up in the pockets of transit workers (as above market wages) or ... suppliers of transit capital (as higher profits and interest)."[163]

---

159 See Vranich, *Derailed: What Went Wrong And What To Do About America's Passenger Trains*, pp. 9-15, 210.

160 Again see U.S. Code, Title 49, Chapter 241.

161 Stephen J. Thompson, "Amtrak And Energy Conservation In Intercity Passenger Transportation," Congressional Research Service, Report For Congress, Updated September 1996.

162 Stephen J. Thompson, "Amtrak: Background And Selected Public Policy Issues."

163 Clifford Winston, "Have Car Won't Travel," *The Milken Institute Review*, Second Quarter 1999, pp. 27-28. Winston bases his statement on (continued...)

Because most of Amtrak's subsidies are diverted by its employees and suppliers, little remains to flow through to Amtrak's supposed beneficiaries, its customers. Even if Amtrak's subsidies were not diverted, it is questionable whether its customers require the government aid. People who travel by Amtrak tend to be well off financially, with incomes far above the national average. Several years ago, 73% of Amtrak's customers had incomes above $40,000, compared to 51% of airline travelers, 38% of private vehicle travelers, and 20% of bus travelers.[164] The government should not discriminate against Amtrak's users because most have higher incomes, but it should not be trying to subsidize them, either.

The federal government is finally beginning to grow restive at the giant subsidies going to its minor player in the transportation network. The Amtrak Reform And Accountability Act Of 1997 established an Amtrak Reform Council to monitor Amtrak's performance and suggest cost and productivity improvements. If the Council determines, at any time after December 2, 1999, that Amtrak will require operating subsidies beyond 2002, it must notify Congress. At that point, the Council must submit to Congress a restructuring plan, Amtrak must submit a liquidation plan, and Congress must consider the matter.

Whether or not this provision is triggered, Congress should reconsider the explicit and implicit subsidies it has been doling out

---

[163](...continued)
two earlier studies, which he cites. Amtrak is unlike most mass transit in that it is primarily between cities rather than within cities. There is no reason to believe, though, that Amtrak's employees and suppliers have captured a smaller share of subsidies than the mass-transit average.

[164] Jean Love, Wendell Cox, and Stephen Moore, "Amtrak At 25: End Of The Line For Taxpayer Subsidies," Cato Institute, Policy Analysis No. 266, December 1996, accessed at Internet site www.cato.org/pubs/pas-pa266.html

to Amtrak for almost 30 years, in light of the organization's persistently high costs and disappointing service. Perhaps the best solution would be to facilitate Amtrak's rationalization and reorganization by selling it to the private sector. That was done in 1987 with Conrail, then a government-owned freight railroad, and Conrail has prospered under private-sector control—without government subsidies.[165]

[165] See Utt, "Congress Should Accept Industry Offers To Buy Amtrak." Utt also examines the privatization of railroads in Great Britain, Japan, Argentina, and New Zealand. Two freight railroads, CSX and Norfolk Southern, were so impressed with Conrail's post-privatization success that they purchased the company for $10 billion. (See Norfolk Southern Internet site www.nscorp.com/nscorp/html/releases97/division.html.)

Conclusion

Government owned or controlled businesses operate according to incentives that discourage efficiency. That is why government enterprises throughout the world have built an alarming reputation for misallocating resources, lowering productivity, and, thus, harming the public. This paper has explored the problems of government enterprises by means of case studies of three government owned or supported businesses: the United States Postal Service, the Tennessee Valley Authority, and Amtrak. The most detailed analysis is provided for the U.S. Postal Service, which is the biggest government-owned business in the nation.

Often, as with Amtrak, the problems of a government owned or associated business are obvious. When an enterprise suffers large or chronic losses that compel it to rely on government appropriations for its survival, people can readily see that the business is performing poorly. They are then likely to ask hard questions about why the government owns or controls the business, what the government business is doing wrong, and whether the private sector could do better.

In contrast, when a government business breaks even or reports profits, it usually claims to be well managed and successful, and is frequently perceived that way. This paper finds that the facts are very different. One reason for the discrepancy between appearance and reality is that government enterprises are usually held to a lesser financial standard than private-sector businesses: breaking even instead of earning a market rate of return.

This study estimates that the gap at the Postal Service between its earnings and those of a similar private-sector business functioning at average efficiency ranges between $100 million and $4.4 billion yearly, depending on the estimation assumptions; the median estimate of the Postal Service's yearly earnings gap is about $1.3 billion. The study likewise estimates the performance gaps at TVA and Amtrak and finds they are large. At TVA, for instance, yearly earnings are between $600 million and $1.9 billion below what would be expected from an average-efficiency private-sector company. Most of the gap is caused by government enterprises using scarce labor and capital resources inefficiently—a loss of potential output and income to the economy—or by government enterprises paying workers and suppliers above-market compensation—an involuntary income transfer from the general public to government employees and suppliers. Little remains to benefit customers of government enterprises, although the enterprises are often defended for supposedly helping customers.

Further, the problems of government businesses are often worse than they seem because many government enterprises receive hidden government subsidies that improve their outward appearance while, perversely, straining government budgets and giving the enterprises greater leeway to indulge their inefficiencies. The concealed government aid includes tax breaks, regulatory privileges, and credit backing.

The paper has estimated the dollar value of some of the main subsidies. The dollar amounts are very substantial, even though the estimates are probably on the low side because of the cautious assumptions on which they are based. The hidden welfare payments from the government to its businesses are a drain on government finances that forces governments to borrow more, raise taxes elsewhere, or cut other government programs.

The study finds that the Postal Service—which brags that it does not cost taxpayers a dime—is likely receiving over $1 billion of concealed government assistance every year just through its principal tax exemptions. It costs federal, state, and local governments still more compared to the taxes and fees that would be generated by private-sector businesses using the same resources but operating at average market efficiency. Similarly, TVA is heavily dependent on government welfare, despite appearing on the surface to cost taxpayers nothing. As for Amtrak, it is a painful lesson that when the government becomes involved in business ventures, it often assumes major risks that later result in very expensive bailouts.

Governments should avoid entering into business ventures whenever possible. Existing government enterprises should be privatized, whenever feasible. And if any remaining government businesses have monopolies, they should be required to leave competitive markets. For example, while the Postal Service claims that it needs to expand in competitive markets, this study has found that removing the Postal Service from competitive markets would be practical and would have the benefits of being efficient, protecting customers within the Postal monopoly, reducing risks for taxpayers, improving government finances, and being fairer to private-sector businesses and their employees.

With businesses that the government continues to own or control, the study's findings strongly suggest that the government-associated enterprises should be denied hidden government subsidies and treated like other businesses. Subsidies strain the finances of the parts of government providing the subsidies and foster misallocations of resources by distorting price signals. Covert subsidies are also undesirable because they mislead the public. Moreover, they are unfair to private-sector businesses competing against subsidized public-sector enterprises. Government enterprises should be taxed like other businesses, regulated like other businesses, and pay interest rates similar to those charged other businesses.

About the Author

Dr. Michael A. Schuyler is a Senior Economist at IRET. He has addressed a wide range of tax and regulatory issues in numerous IRET *Bulletins*, *Congressional Advisories*, and *Fiscal Issues*, concentrating on how government policies change economic choices through the incentives and disincentives they create. He previously examined the Postal Service, the federal government's largest business enterprise, in *Wrong Delivery: The Postal Service In Competitive Markets*. Dr. Schuyler received his Ph.D in economics from the University of Maryland, where he taught courses on macroeconomics and money and banking.