Privatizing the U.S. Postal Service![*]

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In testimony before the House of Representatives Subcommittee on Postal Service on H.R. 22 we argued that the proposal for a form of price cap regulation was unlikely to yield significant benefits as long as the United States Postal Service remained a pubic enterprise. Over a year has passed and H.R. 22 has been revised. However, the Postal Service appears no closer to privatization. The purpose of this paper is to restate and expand the arguments for privatization that we made in the hearings and to examine some scenarios for the operation of a privatized Postal Service. In section one we provide a brief discussion of the current state of postal service, including developments in other countries and why change is required. In section two we examine why privatization should be an integral part of postal reform. In section three we will sketch our views about the direction that privatization the United State Postal Service (USPS) should take. For some our proposals will not go far enough, since they retain the regulated monopoly in modified form. Section four is by way of concluding discussion.

1. The Current State of Postal Service

The Postal Reorganization Act of 1970 provided the basis for the current organization of the U.S. Postal Service and the Postal Rate Commission. This organization has had numerous successes during the last quarter of a century. The regulatory process has emphasized procedural fairness, allowing competitors and mailers a strong voice in the setting of rates and the shaping of new services. Despite the apparent cumbersome, legalistic structure of this regulatory process, it has not stifled innovation. USPS is a world leader in volume of mail, work-sharing discounts, bulk mail, automation, and downstream access. In addition, the rates for basic First-Class mail are amongst the lowest in the advanced economies.

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Despite significant successes postal service in the United States cannot continue in its present form because of major exogenous changes that are not compatible with the current system. These changes include chiefly the emergence of microelectronics, optical fiber, and computer-based alternatives such as the Internet, which have revolutionized traditional communications and advertising.[1] These changes can be a significant source of opportunity for growth in postal and delivery services, but taking advantage of these opportunities will require a move to a more commercial, business-like approach to postal service and the incorporation of regulatory innovations such as incentive regulation. H.R. 22 recognizes this mandate and the dangers of not heeding it.

The United States is not alone in moving toward postal reform. Postal administrations worldwide have been moving toward more commercial operations, including adopting organizational and technological innovations developed in the private sector over the past several decades of increasing global competition.[2] The rationale for more commercial operations is simple: increased competition from other communication modes, as well as alternative delivery services, have meant that the traditional civil service bureaucracy coupled with the traditional regulatory process respond too slowly to emerging market realities. What is required is a market-oriented approach to align the incentives and operations of economic agents involved in postal and delivery services with the needs of their customers. In short, exogenous changes in both markets and technologies of postal and delivery services imply an unavoidable requirement for a significantly greater business orientation in the postal sector.

The changes required to achieve an increased commercial orientation are not just internal to the U.S. Postal Service, but also involve reforms in the regulatory process. It is important to note at the outset that national postal administrations will continue to enjoy residual market power for some time. This means that regulation will continue to have an important role in balancing increased commercial incentives for static and dynamic efficiency, while restraining the exploitation of market power. Postal service is not unique in this regard, and we have seen a similar evolution in other network industries that have undergone the transformation from traditional cost-of-service regulated

[1] For a discussion of recent technological and marketing trends in postal and delivery services worldwide, see Crew and Kleindorfer (1997).

[2] For a discussion of international trends and issues in postal reform, Crew and Kleindorfer (1995). and Crew and Kleindorfer, 1997, *op. cit. supra*. Very recently, the Communications Workers Union in the U.K. has put forward its proposals for mail ("Freedom to Deliver—Posting the Way to Greater Success," CWU, London, February 1997) which propose turning the U.K. Post Office into an independent corporation within the public sector, and the creation of an independent regulatory agency administering a scheme of price-cap regulation.

monopolies to more competitive structures. Indeed, the experience from such industries as telecommunications and energy is of considerable value for the postal sector, as this experience has provided the direction for understanding the necessary regulatory innovations to achieve the transition to greater competition. The general character of these innovations has been to provide greater autonomy to the incumbent service provider for pricing and product innovation, while encouraging competitive entry into all parts of the value chain except for those displaying the natural monopoly attributes of overwhelming scale or scope economies. In postal service, as in electric power and telecommunications, it is only in the area of "local delivery" that a strong case can be made for the existence of natural monopoly.

The experience in other countries and other industries suggests the key themes that should guide the introduction of reforms in the postal sector. First, the above noted transformations to greater commercialization and streamlined regulatory governance are central. Second, in order for the U.S. Postal Service to align its internal incentives with market requirements, employees of the Postal Service must be given both the rights and the responsibilities of "residual claimants" in USPS. This implies a stronger link of the economic results of the Postal Service to the salaries and wages of these employees. In particular, the combination of current labor-relations practices and cost-plus regulation have led to a situation in which USPS employees have enjoyed a significant premium over similarly situated employees in the private sector.[3] Under increasingly competitive conditions this state of affairs would not be able to continue for long were the Postal Service not a public enterprise with a statutory monopoly and with its finances underwritten by the U.S. Government. However, with public enterprise the static inefficiencies implied by this wage differential can continue. Similarly, the beneficial effects of competition and technological change will be attenuated under public enterprise. To attain the potential benefits of technological change, competition and price cap regulation, privatization is required. H.R. 22 in its present form fails to take the most important step toward reforming the USPS. Compared to privatization, most of the changes proposed are cosmetic. Let us now examine some of the consequences of making privatization the centerpiece of postal reform.

2. Privatization – the Centerpiece of Postal Reform

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[3] Perloff and Wachter (1991) estimated the magnitude of the postal employee wage premium at 28%.

The forces of technological change, increased competition and a different attitude to monopoly regulation mean that the time is ripe for serious reform of the postal sector. In the United States reform is underway with H.R. 22. However, H.R. 22, while subscribing to the notion of regulatory reform and incorporating some recent developments in "regulatory technology" in particular price cap regulation, misses the opportunity for serious regulatory reform in that it fails to grasp the nettle of privatization. Privatization of the USPS and postal service in other countries is the key element to successful, efficient and innovative postal networks.

There are no strong technological, strategic or economic reasons why postal service should be publicly operated. While it may be difficult to make a case for privatizing the armed services, there are no such strategic considerations with postal service. Postal service is a network industry. Other network industries, for example, electricity, gas and telecommunications are privately owned and operated.[4] Postal service is arguably less important to the economy than any of the other network industries. It would be much more painful if the lights went out for half a day than if postal service ceased for an extended period. There would be inconvenience if the mail did not get delivered but the ready availability of (imperfect) substitutes would mean that severe disruption could be avoided.

Operating USPS as a public enterprise is a political matter that is in the hands of the Government. It remains a public enterprise despite the many advantages in having a privatized Postal Service. For example, a private sector Postal Service would be subject to different competitive rules than a public enterprise and would have the potential of being more efficient than a public enterprise. To some extent H.R. 22 recognizes the potential of putting private enterprise to work in the U.S. Postal Service by changing the competition rules and by subjecting USPS to price cap regulation. Both of these are artifacts of privately owned regulated companies. However, H.R. 22 fails to privatize the USPS, the vital step that is necessary for legislative changes to bring about their intended benefits. We will not get involved in the details of H.R. 22 but will be concerned with the consequences arising from the failure to privatize.

[4] Water utilities are mostly publicly owned but there is a trend toward privately managed operations through contracts with privately owned utilities.

Price cap regulation (PCR) is the most significant change in regulation embodied in H.R. 22. It differs from traditional cost-of-service regulation in that it does not restrict the profit that the firm can make to the cost-of-service including an allowed rate-of-return on its capital. It sets the maximum price level[5] that the regulated firm may charge and then allows the firm to keep the profits that it makes. It also allows the firm to raise its prices over time by a specified amount, namely, the annual increase in the index less X, where X is a percentage deduction from the annual increase in the index. Thus PCR appeals to the firm's incentive to maximize profits and, in so doing minimize costs and otherwise operate efficiently. The efficiency of PCR comes in the form of lower costs as a result of the operation of the profit motive. To be effective PCR requires the profit motive which requires residual claimants if its is to operate. Absent residual claimants PCR lacks the incentives for efficiency that support its implementation.

Residual claimants readily exist in the case of private companies whose objective is profit. The stockholders are the recipients of the residual in the case, namely profits. Management, by means of appropriate executive compensation schemes, for example, stock options, can be made to face incentives such that they share the stockholders' objective to maximize profits. The capital market also operates to provide further incentives to management to maximize profits. The market punishes poor management by driving down the price of the stock and by the threat of takeover.

With public enterprise there is effectively an absence of residual claimants. The government's interest is entirely too diffuse. Moreover, with public enterprise the discipline of the capital market is absent. H.R. 22, in proposing PCR, fails to take into account the absence of residual claimants in the public sector. In addition, it completely ignores lessons learned elsewhere. It is no coincidence that incentive regulation, and specifically price-cap regulation, has been applied almost exclusively to privately owned companies, rather than public enterprises. Notably in the United Kingdom, price-cap regulation was the regulatory scheme adopted for the newly privatized enterprises not only among network industries, viz. gas, electricity, telephone and water, but also for other industries such as the British Airports Authority. The U.K. Post Office was not privatized and not subject to price-cap regulation. Similarly, in the U.S., price-caps have applied primarily to telecommunications companies. The fact that these companies are privately owned largely explains

[5] This is normally based on a price index, for example, the Laspeyre index, which allows the firm to set its prices within the limits of the index.

the potential of price caps in achieving more efficient operation than cost-of-service regulation. Under price caps, shareholders and top management, as residual claimants, have the opportunity to enjoy the extra profits that result from increasing the efficiency of operations. However, if the Postal Service were subject to price cap regulation with no change in ownership or residual claimants, there is absolutely no guarantee that efficiency will be improved, as there would otherwise be no, or at best weak, residual claimants to benefit from increased profits. Indeed, additional profits might be arguably counterproductive, in that they might send a signal to postal employees that the Postal Service could pay more. Unlike a private company, the Postal Service, absent any other strong residual claimants,[6] would have little incentive to stand firm, as management would have little to gain from doing so. In addition, a public enterprise is not subject to the pressure of competition in the same way that a private company is, in that it is insulated from bankruptcy. This insulation from the discipline of bankruptcy also means that a public enterprise, unless strongly reined in by the government, can get into competitive ventures on favorable terms and therefore compete unfairly and inefficiently with privately owned companies.[7]

Absent privatization, there is no strong residual claimant to assure a proper allocation of scarce resources. Some efforts can be made to establish residual claimants by allowing for strong management incentives and profit targets as, for example, has been the case in Australia and New Zealand, where the post offices are still public enterprises. However, the government's powers to punish failure are weak compared to the market. Thus, in Germany and the Netherlands, the incentives for efficiency may be stronger, as in both cases either a schedule for privatization is in place or some portion of the stock is already privately owned. The implications for the U.S. Postal Service are clear. Absent privatization or a schedule to privatize, the benefits to be expected from incentive regulation are likely to be reduced significantly.

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[6] It is difficult to argue in a credible manner that taxpayers are meaningful residual claimants..

[7] The revised H. R. 22 recognizes some of these problems in that. However, the approach proposed in H.R. 22 may be exceedingly difficult to administer. It has a number of provisions requiring clear accounting separation of competitive and noncompetitive products. Given the common resources used to provide many of the most obvious competitive products, attempts at separation will undoubtedly lead to many complexities and additional regulations in sorting out what resources are used for various products and what cost responsibilities are to be assigned to these products. The potential for strategic behavior to discourage entry exists in public enterprise, as a recently documented example of cross subsidies of competitive by monopoly products in the case of the Federal Reserve Board illustrates (Cavalluzzo et al. (1998)). Thus, we would not be sanguine about the ability of regulators to achieve either efficiency or clear separation in the provision of competitive and noncompetitive products if the U. S. Postal Service continues as a public enterprise.

Similarly, in the absence of privatization and residual claimants there is little incentive on the part of Postal management to address the issue of the current labor relations framework within which the U.S. Postal Service operates. Unless there is a change in labor practices, the improvements in efficiency are likely to be small or non-existent. The current system involves binding arbitration. Thus, approximately 80% of the Postal Service's costs are effectively subject to the decision of an arbitrator.[8] The arbitrator is not obliged to abide by the price cap. He may award significantly in excess of the rate of increase allowed by the price cap. If this happens, the Postal Service would have no alternative but to seek rate relief on the grounds of impending financial exigency! With this system of labor relations, which arises from the public enterprise status of the U. S. Postal Service, there is thus little likelihood that the benefits of cost economy promised by price caps will be achieved in the Postal Service.

3. **Regulation of The United States Postal Service, Inc. (USPSI)**

In this section we will sketch a possible scenario for the future of a privatized postal service, the United States Postal Service, Inc, (USPSI).[9] Like H.R. 22 we see USPSI as a continuing regulated monopoly. Like H.R. 22 we would propose changing the monopoly from the current arrangement of three dollars or twice the postage whichever is greater. However, our approach would be to limit the monopoly beyond the proposals in H.R.22. We would confine the monopoly to a monopoly in local delivery.

We see our proposal as part of an evolving process. Entry has been taking place in postal service and fixed network industries over the last ten years or so. Indeed, the U.S. Postal Service faced entry into its business at an early stage in the form of worksharing, namely discounts for presorting. Unlike privately owned companies it did little to oppose entry in this form. Similarly, its parcels business was devoured by UPS and FEDEX who came to dominate courier service. Now postal administrations in Europe and the U.S. are beginning to face more serious threats to their traditional and basic letters business. The issue of regulatory governance when entry is allowed is now becoming as important as it is in the other network industries.

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[8] Approximately 80% of USPS costs are labor of which about 80% are subject to the decision of an arbitrator. However, management and staff compensation follow the arbitrator's award. For an excellent survey of postal labor relations, see Froelke (1998).

[9] We are confining our attention to regulation of USPSI and will not discuss major open issues, e.g., finance and labor relations. See Froelke(1998) for some ideas on possible reform as a prelude to "privatization" of postal labor relations.

Entry by competitors in network industries has not been complete, as not all parts of the value chain are a natural monopoly. Some parts of the industry can be successfully subjected to competition but that there is a residual monopoly, bottleneck or essential facility. As we argued in Crew and Kleindorfer (1998), making network industries more competitive may require the acceptance of some residual monopoly. We argued that, in these circumstances, the feasible approach was to recognize the inevitability of some regulation of the residual natural monopoly. The approached we proposed was to pare down the residual monopoly to the minimum and regulate using a form of price cap or incentive regulation. This is the approach we would propose for the regulation of USPSI.

Currently, the postal monopoly or reserved area is usually defined in terms of a weight or monetary limit. For example, the British Post Office has a monopoly of letters priced below one pound Sterling. H.R. 22 proposes lowering this limit but is not expected to make any more radical changes in the approach. In addition, the Postal Service has a mail box monopoly. We take a more radical approach to the regulation of USPSI. We would argue that many of the upstream services such as collection, transportation and mail processing could be subjected to increased competition with local delivery remaining as a regulated monopoly. The postal monopoly would be confined to the local delivery network only. Local delivery would be the core or residual monopoly. USPSI would take on the role of suppliers of services wholesale and not having any retail customers. Postal administrations would provide only the local delivery networks and the sortation needed for local delivery.

Although we are not going into the details at this stage, we should emphasize that our proposal would not affect the rights of couriers and parcel operators to deliver as currently. They would be under no obligation to use USPSI's network for their existing services. USPSI would have a monopoly on local delivery of letter mail and small packets up to some dollar limit. This dollar limit would likely be less than the current limit. For example, it might be in the range of two dollars.

The problem with this proposal is that it would potentially leave most residential postal customers high and dry for some services. Unlike the other network industries, it is unlikely that in postal service the competitive market has the potential to rebundle the services required for residential and other small customers to obtain fully integrated or end-to-end service. In postal service there may be major problems of bundling together the various parts of the postal value chain needed to provide end-to-end single piece service for residential or other small customers. This is because a postage stamp, unlike a utility bill is a low value item leaving very little scope for competitors to bundle the services necessary to provide single-piece service. This is likely to be an even more important problem in rural areas, which receive service only because of cross subsidization. These areas are not only highly vulnerable when it comes to delivery but also when it comes to collection. Similarly, very small residential customers, the Aunt Minnies, might be almost completely cut off from sending letters absent the "lifeline" offered by postal administrations. We are saying, in effect, that we cannot see much if any interest in end-to-end single piece service for residential customers. However, because of potential scale economies arising from their collection networks most postal administration could handle this kind of business and receive a contribution over variable costs. We would therefore argue that the postal monopoly should consist of local delivery but that USPSI would also be required to provide single-piece end-to-end service.

This requirement to provide end-to-end service does not result in an increase in postal monopoly power but, rather, an increase in its universal service obligation (USO). While it would be obliged to offer single-piece end-to-end service there is nothing to stop consolidators from collecting mail from small customers into large batches of mail for presorting or barcoding. For large users this is done now. Some small customers might have this option if the market offered sufficient profit to make it attractive to entrepreneurs. Indeed, customers who would be targeted for this option would likely be postal administrations' profitable customers, i.e.; the potential for cream skimming would exist. However, the gains from competition here are likely to be greater than the losses from cream skimming. Given that the postal administration has a monopoly in local delivery, through which it would fund its USO we are not concerned that such losses, if any, would affect the financial viability of the postal administration or threaten its ability to meet its USO. Another reason for taking this route is that funding the USO in the postal context through uniform pricing and the local delivery monopoly would likely be preferable to setting up a universal service fund, as is the case in telecommunications. [10]

As in the case of H.R. 22 USPSI would be subject to a form of price cap regulation or incentive regulation. Again without going into details, it is clear that the choices are between pure price

[10] We have examined the USO in a forthcoming paper (Crew and Kleindorfer, 1998).

cap regulation and hybrid price cap regulation.[11] Pure price cap regulation allows the regulated firm to keep any profits it earns within the price cap constraint. Hybrid price cap regulation allows the firm to retain only a percentage of the profits it makes above a certain return on its assets. Such hybrid forms of regulation provide considerable flexibility. We do not examine specific proposals here as our basic point is that none of these are likely outperform the current cost-of-service system in the absence of privatization.

Irrespective of the form of price cap regulation adopted setting the starting point is a critical part of the process. The most likely approach is to have an initial rate case which essentially took a traditional cost-of-service approach based upon expected expenses and a rate of return on the invested capital or rate base. This would establish the initial prices that would then become subject to a price cap index. The individual products would have to be placed in "baskets" for purposes of the price cap.[12] One approach would be to have two regulated baskets, for example, an "access" basket and a "single-piece" basket. Each of these baskets would be subject to the price cap index. The index would be based on say the CPI minus X. Setting the X factor would be quite important. It would have to recognize that, unlike telecommunications, technological change and demand growth are not rapid. This would imply a low X factor. After a period of say five years, the price cap period, prices and the X factor would be reviewed, following standard practices in the implementation of price cap regulation.

4. Summary, Conclusions and Implications

We see considerable potential for increased efficiency arising out of our proposal. Despite the obligation to provide single-piece end-to-end service, our proposal would orient USPSI very much toward local delivery networks. One likely consequence would be an increase in potential organizational innovations, as well as more rapid development and adoption of new technologies. For example, one area of organizational innovation is the potential for much more contracting out. USPSI might auction of franchises for local delivery networks to independent contractors. USPSI would, in effect, take on the role, similar to McDonalds, of a franchisor of local delivery networks. Some of the networks would be operated by franchisees while others would be owned and operated by USPSI. The role of USPSI, as franchisor, would include quality control. It

[11] These terms are discussed in Crew and Kleindorfer (1996) and Kridel, Sappington and Weisman (1996).

[12] The index would apply to each basket separately. For example, if USPSI chose to raise one basket by less than the allowed amount this would not be allowed as a credit to the other basket. One of the purposes of baskets is to restrict cross subsidization of competitive products by monopoly products.

would have to set standards for the franchisees and monitor the franchisees to see that the standards were being achieved. It would also be able to benchmark the performance of franchisees against one another and against networks its still continued to operate.

Normally the franchisee would operate out of a post office or other postal facility. However, the choice of different franchise arrangements is considerable. In some cases USPSI might provide the trucks as well as the physical facilities. In other cases the franchisee might provide all trucks and facilities and there are various possibilities in between. Franchising would have the effect of reducing employment by UPSPI compared to the current USPS. However, total employment is unlikely to decline dramatically, as the franchisees would require labor. It is expected, however, that competitive pressures would result in cost savings and other efficiencies on the part of franchisees.

We could go on at length as to the potential benefits from privatization of USPS and the creation of USPSI. However, we should conclude with a dose of reality. We recognize that privatization of the United States Postal Service or USPSI is no more than a dream at this stage. This does not reduce our belief that it should happen. Whether it will happen is a political matter. This would get us into the realm of public choice theory, which is beyond the scope of this paper. However, it may provide the opportunity for fruitful research into the political feasibility of privatization.

We thank CATO for providing us with this opportunity to examine the economic case for privatization of the Postal Service. We conclude that the case is strong. While we recognize that a powerful case does not imply political feasibility we also know that political decisions arise from ideas. Privatization of the Postal Service is an idea whose time is overdue.

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