
9 Postal privatization in the United States

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Introduction

In this chapter we examine the role of privatisation in postal services, with the main emphasis being on the role of privatization in the case of the United States postal service (USPS). The problem is not an easy one. USPS has an inefficient organizational and governance structure that precludes alignment of market and efficiency incentives with investments and operations. At the same time, USPS has a universal service obligation (USO), which is both a curse and a blessing, in that it is the source of large costs but also represents the basis for legitimating its letter monopoly and other privileges. Finally, in the face of both of these factors, USPS has additionally an institutional governance structure with respect to its primary input, labour, that effectively precludes an efficient response to changing market conditions, especially any such conditions requiring a smaller labour force.

Under the circumstances, it is exceedingly difficult to sort out what elements of USPS behaviour are absolutely essential for the viability of the USO and what elements are unnecessary infringements on the market in the form of anticompetitive behaviour. This is not a new problem in network industries. In the case of USPS it may be more severe because of the nature of the postal service, the nature of the USO and the politicization of decision making resulting from the public ownership in the USA and the oversight role exercised by the legislative and executive branches of government. Given these arguments, it might seem that privatization is the obvious solution and, only recently, Crew and Kleindorfer (2000) argued for it. However, a little over three years later, no progress has been made towards privatization and, at least in the short term, it appears less feasible. In some respects, however, the case is stronger. How can this be when other post offices (POs), notably those of the Netherlands and Germany, are partially privatized and most of the POs in advanced economies are becoming increasingly commercialized?

This chapter, in exploring the potential future privatization of the postal service, begins with a short discussion of privatization and some background on the nature of the postal service. The chapter then examines some of the approaches taken, including comparing the experience in the USA with that of other countries, especially the privatized postal services of Germany and the Netherlands. The discussion then turns to examine the

option of privatization of USPS and, later, the way forward, particularly for USPS. The chapter ends with a brief summary and conclusion.

Background on postal service and privatization

‘*Privatisation* is not only an inelegant term; it is also lamentably imprecise . . . One major source of confusion is the difference between privatisation in the United States and the rest of the world’ (Donahue, 1989). Privatization, at its most general, is the transfer of services that were formally under government control to private control. At one extreme it may involve the government selling its ownership rights in the form of an initial public offering (IPO) of stock to individual shareholders, notable examples being the sale by the United Kingdom of its telephone, electricity, gas and water utilities to individual shareholders. At the other extreme, privatization may not involve selling any assets and may mean as little as contracting out certain tasks that were previously performed within the public enterprise. A municipal water undertaking might contract out the management of its operation to a management company, which may itself be a subsidiary of a privately owned company. Many municipal services may be contracted out to franchisees. All these kinds of activities can be a privatization of varying degrees that falls short of government actually divesting its ownership so that the equity is privately held. Many privatization arrangements of this kind exist. A prison system might contract out the operation of one or more of its penitentiaries to a private company, or a private company might own and operate the prison properties itself, charging a fee per inmate to the government. We are not going to describe such arrangements in any detail as they have been extensively analysed elsewhere (for example, Shleifer, 1998). However, the lesson for the postal service is that privatization can take many forms and is not just confined to divesting the equity ownership to the private sector.

Privatization, in the sense of divestiture of the equity from public to private hands in the form of an IPO, has never been seriously considered by policy makers in the debate to reform the postal sector in the United States. However, USPS has privatized extensively, more than any other PO, individual pieces of the value chain through contracting to private companies and by encouraging entry of privately owned competitors into the upstream value chain. This includes not just barcoding and pre-sorting but also downstream access, namely, drop shipment to the delivery office. Reform of the postal sector was precipitated by crises in the late 1960s resulting in the Postal Reorganization Act of 1970, which provided the basis for the current organization of the US Postal Service and the Postal Rate Commission. Although the 1970 Act abolished the United State Post Office because of a crisis, which had been largely the result of mismanage-

ment stemming from running it as a government department, it still retained public ownership in the form of a public enterprise, USPS. The new entity was intended to be more independent of political interference than the old USPO, with its own board of governors appointed by the President of the USA. However, it has proved impossible for USPS, organized as a public enterprise, to avoid operating in a political manner. It remains a public enterprise and, despite fairly widespread concerns about the state of USPS and many potential advantages in having a privatized postal service, it is unlikely that USPS will be privatized in the near future, at least in the sense of ending public ownership.

The arguments that private ownership is likely to be more efficient than public ownership are well known and so we will summarize them only briefly here with USPS in mind. Not all economic activities are more efficiently supplied by the private sector. For example, it is not clear that prisons, law enforcement, national defence and tax collection should be privatized in any significant manner. So we confine a discussion of the advantages, in principle, of privatization to the case where there are no strong reasons for public ownership and operation. Postal service clearly meets this test. There are no strong technological, strategic or economic reasons why the postal service should be publicly operated. Postal service is a network industry. Other network industries, for example, electricity, gas and telecommunications, are privately owned and operated.¹ Postal service is arguably relatively less important to the economy than any of the other network industries. It is an old industry with its origins before the industrial revolution. While it has changed dramatically in certain respects, it has not changed anywhere near as much as the rest of the communications sector, making it relatively less important than in its early days. It would be much more painful if the lights went out for half a day than if the 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. On the face of it, therefore, the postal service looks like an excellent candidate to reap the advantages of privatization.

In principle, residual claimants drive the benefits of privatization and the inefficiency (X-inefficiency) of public enterprise arises from the lack of residual claimants (see Chapters 2 and 3). Residual claimants readily exist in the case of private companies whose objective is profit. The stockholders are the recipients of the residual in this 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 board of directors is intended to provide oversight of the management of the company

and act as the fiduciaries of the stockholders.² 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. Competitive product markets further sharpen the incentives to operate efficiently. The objective of profits – the excess of total revenues over total costs – provides an incentive for cost economy and therefore X-efficiency.

By contrast, incentives in public enterprise are much softer, given the absence of effective residual claimants. The government's interest is entirely too diffuse. Moreover, with public enterprise, the discipline of the capital market is absent. On a priori grounds, the case that private ownership is likely to promote greater X-efficiency is very strong. The question is whether it is supported empirically. Donahue (1989: 76) cites a number of studies in the 1970s and 1980s that show no significant differences between private and public electric utilities. However, as Crew and Kleindorfer (1990) noted, there may be problems with the treatment of the cost of capital in these studies. Most of the public entities had tax advantages that lowered their cost of capital, thus diluting the credibility of arguments made that costs of public enterprises were lower. In addition, the period covered was when electric utilities were subject to cost of service regulation, also known as rate of return regulation (ROR). This type of 'cost-plus' regulation was likely to attenuate the incentives for efficiency and cost economy. Recently, regulation has moved very strongly towards incentive regulation (see Chapters 23 and 24), and it is not by accident that this trend has been tightly linked to privatization and the residual claimancy it embodies. For example, Littlechild's (1983) proposals for incentive regulation, specifically price-cap regulation, clearly presuppose residual claimants. Indeed, they were applied almost exclusively to privately owned companies, rather than public enterprises. Notably in the UK, price cap regulation (PCR) 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 Britain's major airports. Similarly, in the USA, price caps have been applied primarily to telecommunications companies. The fact that these companies are privately owned largely explains 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.

Meggison and Netter's (2001) survey of the studies of recent instances of privatization provides a comprehensive study of whether private firms are likely to be more efficient than public enterprise. Their paper provides comparative longitudinal evidence from a number of sectors on performance

before and after privatization. Moreover, incentive regulation, which specifically aims to encourage efficiency, was extensively employed for many of the companies during the period surveyed. Megginson and Netter conclude, 'Research now supports the proposition that privately owned firms are more efficient and more profitable than otherwise-comparable state-owned firms' (*ibid.*: 380).

Given the generally promising effects of privatization, it seems that privatization of USPS at a minimum has the potential to improve efficiency relative to the current situation. In view of the concern for the situation currently faced by USPS, the time would appear to be apposite to consider privatization as a possible reform strategy. To understand whether and how this might occur, however, we must first consider the central problems now confronting USPS and other POs worldwide. USPS and most postal services face three major problems which policy makers are aware of, and we now consider them.

First, the USO is generally, but by no means universally, recognized as a significant burden.³ In addition, the postal service is not the only industry with a USO. It is a burden imposed by government on almost all other regulated network industries.⁴ In the case of postal service it has two features, ubiquity and uniformity. Ubiquity means that it must collect and deliver everywhere in the country, to every address. Uniformity means uniformity of price irrespective of where the delivery or collection takes place. Letters (not parcels) are subject to the price uniformity requirement. All letters of the same weight carry the same postage. Similarly, service standards are subject to uniformity standard, in that they are managed within narrow limits. First class mail in the USA is delivered overnight within a defined area and otherwise within two or three days depending on distance and the outlying nature of the delivery point. The success in meeting the service standards is evaluated by an independent consulting company.

Second, X-inefficiency is a major problem for postal services, including USPS. Part of the inefficiency can be traced to the absence of residual claimants as drivers of efficiency. Another source is the nature of postal service. It is extremely labour-intensive, with over 80 per cent of total costs being labour. It is at least strongly arguable that these problems may be relatively greater for USPS than for most other POs. 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 labour relations framework within which USPS operates. Unless there is a change in labour practices, the improvements in efficiency are likely to be small or non-existent. The current system involves binding arbitration. Thus approximately 80 per cent of the postal service's costs are effectively subject to the decision of an arbitrator. The arbitrator is not obliged to abide by considerations of USPS finances,

and has little incentive to do so as USPS is a public enterprise that does not face the discipline of bankruptcy.

Third, postal service, especially the delivery of letters, is faring badly as a result of technological change in the economy that has improved the prospects of other sectors at its expense. Optical fibres and computers have had a dramatic impact on the economy. A new sector, the Internet, has grown from a tool used by scientists to a ubiquitous phenomenon. The marginal costs of employing the Internet, for example, are near zero, in contrast to the marginal cost of a traditional letter. The impact of the Internet is truly monumental and it will be a significant and continuing threat for the traditional postal service. In addition, while the Internet and associated developments in information technology have had a considerable impact on cost reduction, quality and new product offerings in other sectors, the same cannot be said for the postal sector. Notably, USPS has not benefited much on the production and marketing side from the information technology (IT) revolution and it has been hurt significantly on the demand side. By contrast, its major competitors, for example, United Parcel Service (UPS) and Federal Express (FEDEX), continue to benefit from improvements in IT and the Internet by introducing features that enable the shipper to arrange pick-ups, receive bills and track and trace their packages over the Internet. Unfortunately for USPS, the adverse effects on the demand side show no signs of abating and may even be growing in magnitude.

These three problems are considered central to most postal services worldwide. The first two have existed for many years. The third is more recent and its importance has only started to be understood in recent years. Indeed, it is still being addressed. We might have listed a fourth problem, namely the vulnerability of postal service to terrorist attack, as dramatically illustrated by the very recent episode of anthrax in the mail and the major disruption that this caused for the affected postal facilities and customers. As yet this has been a phenomenon confined to the USA and so we have not listed it as a general problem. In addition, since we are concerned with reform efforts generally, we will leave this problem until we discuss potential reforms for USPS. Reform efforts in the USA have attempted to address the three problems highlighted, as have the reform efforts of other countries. Countries have, in effect, addressed these problems in a variety of ways. In the next section we compare and contrast the approach taken by the USA to the privatization approach taken by the Netherlands and Germany.

Privatization and postal reform

The forces of technological change, increased competition and a changing approach to monopoly regulation mean that the time is ripe for serious reform of the postal sector. Privatization of USPS and other POs has the

potential to play a major role in transforming POs into successful, efficient and innovative postal networks. In the USA, while there has been a significant interest in reform, serious debate and a high degree of legislative activity, little has been achieved, in contrast to some of the changes in Europe.⁵ The reforms in the Netherlands and Germany have been far-reaching and include privatization. This has not been the case in the USA. We will review the reforms in these three countries in turn.

Despite the reforms of 1970, operating USPS as a public enterprise remains a political matter that is in the hands of the government. It continues to be a public enterprise despite the many advantages of 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. In the USA, the proposed legislation, H.R. 22, was the most significant attempt at reform since 1970 and it failed ultimately, being abandoned in 2001. It had a number of innovative and significant proposals, the most important being a change in regulation from the current system, which is a form of cost of service regulation, to price cap regulation (PCR). PCR 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 level⁶ 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. The setting of X involves some judgment on the part of the regulator and its level is closely related to the expected changes in efficiency of the company, as examined in detail in Crew and Kleindorfer (1996). Thus, by regulating the price level without direct regard for costs, 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 it 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, namely profits. Management, by means of appropriate executive compensation schemes, using stock options and performance-based bonus payments, 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 the value of the firm,

notably through punishing 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, as the government's interest is entirely too diffuse, and the discipline of the capital market is absent. H.R. 22, in proposing PCR, failed to take into account the absence of residual claimants in the public sector. In addition, it completely ignored 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 to public enterprises. The fact that these companies were privately owned largely explains 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 USPS were subject to price cap regulation with no change in ownership or residual claimants, there is absolutely no guarantee that efficiency would be improved, as there would otherwise be no, or at best weak, residual claimants to benefit from increased profits. Indeed, additional profits might arguably be counterproductive, in that they might send a signal to postal employees that the postal service could pay higher wages. Unlike a private company, the postal service, absent any other strong residual claimants,⁷ would have little incentive to stand firm against wage demands, 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 subjected to certain restriction, can undertake on favourable terms competitive ventures, which may include ill-conceived and risky ventures and have the potential for competing unfairly and inefficiently with privately owned companies.⁸

The importance of residual claimants has not been ignored completely in the postal sector. Short of privatization, the usual approach has been to promote strong management incentives for performance through executive 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 those of the market. The problem is that a public enterprise cannot go bankrupt and bankruptcy is an important stick in private enterprise that encourages management to be cost-conscious and avoid overly risky ventures. Without this stick, it is more difficult to design incentive contracts for top management because of the asymmetry implied by the carrot alone. This stands out in contrast to Germany and the Netherlands, where this problem should be

absent and the incentives for efficiency should be stronger, as in both cases they are well advanced on their schedule for postal service privatization with a significant portion of the equity already privately owned. The implications for the US 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.

Similarly, in the absence of privatization and residual claimants, there is little incentive on the part of management to address the issue of the current labour relations framework within which the US postal service operates. Unless there is a change in labour practices, the improvements in efficiency are likely to be small or non-existent. The current system involves binding arbitration.⁹ With almost 80 per cent of the postal service's costs effectively subject to the decision of an arbitrator and with the arbitrator not obliged to abide by the price cap, this drastically reduces the likely efficiency gains from a price cap. The arbitrator may award wages significantly in excess of the rate of increase allowed by the price cap. If this happened, the postal service would have no alternative but to seek rate relief on the grounds of impending financial exigency! With this system of labour relations, which arises from the public enterprise status of the US postal service, there is little likelihood that the benefits of cost economy, promised by price caps, would be achieved in the postal service.

Although well intentioned, H.R. 22 was fatally flawed, as was argued in Crew and Kleindorfer (2000). This stands in contrast to the experience in Germany and the Netherlands. For at least a dozen years the Netherlands has been a force for change in the postal sector. The Netherlands and New Zealand were among the first of the POs to recognize the importance of becoming more commercialized, as examined by Toime (1991). The Netherlands embraced privatization, while New Zealand Post adopted a corporate structure that was wholly owned by the government. It continued to be innovative, but privatization is not expected to be part of its future. The Netherlands and Germany have been the only major POs to embrace privatization. We will therefore briefly review their experience and possible lessons learned.

The process that led to privatization of the Netherlands' PO traces its roots to 1989, when its structure was changed from a state enterprise to a private company whose stock was entirely owned by the government. Shortly after this, a close commercial relationship began to develop between the PO and TNT, an international express carrier with its origins in Australia. In 1994, the Dutch government sold 30 per cent of its shares in KPN, the combined postal and telecommunications operator, and in 1996 another 25 per cent, making it a minority stockholder. In 1996, KPN acquired TNT. In 1998, KPN divested its postal and telecommunications

into two separate companies. Over the next two years or so it formed alliances with other POs, perhaps the most significant being the formation of a joint venture with the UK and Singapore POs to provide service in cross-border mail. In 2000, it acquired CTI LOGISTX. Its various businesses are grouped together in a holding company called TPG. Although it is a large company with around 130000 employees and with revenues of almost €10bn, it has not been the subject of major litigation. Its success has arisen from a solid base of mail upon which to build. Its USO is less onerous than most, the Netherlands being a small, densely populated country. In addition, it has traditionally received favourable treatment in its reserved area. The weight limit for mail reserved as a monopoly until recently was 500 grams, but is now 100 grams in line with the limit set for January 2003 for the entire European Union. While the Dutch may no longer be able to count on relaxed regulation, they are likely to remain the beneficiaries of a minimally burdensome USO.

A dozen years or so ago the Deutsche Bundespost was in poor shape. It was an extremely ungainly bureaucracy, whose position was made more difficult by the unification of East and West Germany. The East German PO was very overmanned and assimilating it into the new Germany looked like a very difficult task unless something drastic was done. The solution adopted by Germany was to hire a successful manager and businessman, Klaus Zumwinkel, to commercialize the operation. This culminated in the sale of around a third of the equity in 2000 and the transformation of the bureaucracy into a major multinational corporation.

The transformation of Deutsche Post World Net from a bureaucracy to a multinational corporation was a major one and was achieved in a number of ways. The internal organization was transformed by changing the compensation structure and importing managers from other industries, by modernization of the mail and parcels network within Germany, by developing new products, for example, hybrid mail and e-commerce, and by acquisition. Deutsche Post World Net has interests in not only the traditional mail and parcels businesses but also express mail, logistics, banking and more. With total revenue of €32.4bn in 2000 and total employment in excess of 300000, it is one of the world's largest corporations.

The path from bureaucracy to one of the world's largest companies began with major internal changes and encountered a number of hurdles on the way, some of which still remain. The company will face many more difficulties in the future as a result of its policy of aggressive growth and its size. It is and will continue to be a competitive threat not just to other POs including USPS but also to other major players in the delivery and logistics business. It has already been the subject of litigation from major companies, notably UPS. The principal cases before the European Commission

involved alleged anticompetitive conduct, from cross subsidy and from improper state aid. The allegation was that it cross-subsidized competitive products, notably parcels, from its monopoly in letter mail. On 20 March 2001, a ruling of the Commission stated that cross-subsidy took place only prior to 1996 and no fine was imposed. However, a fine was imposed for the use of a loyalty rebate.

A case on state aid is pending. This case alleges that Deutsche Post improperly used state aid and the funding that it earned from its letter mail monopoly to acquire other companies. At first sight this seems to be the traditional red flag that is raised about public enterprise 'playing with the house's money' to the unfair advantage of private companies competing without the benefit of state aid. One argument would be that a public enterprise cannot go bankrupt and so if it is allowed to enter competitive businesses it has a huge advantage over private companies, who have to raise funds without government guarantee and who face the real threat of bankruptcy and takeover. However, this argument loses a considerable amount of its force in the situation where a government has made and announced an irrevocable decision to privatize, which the German government has done in the case of Deutsche Post. It even went as far, in 2001, as to change the German constitution to underline the credibility of its commitment to privatize. Without the change in the constitution, the sale of the equity would have been limited to 50 per cent. The amendment to the constitution makes it possible for the government to sell the entire equity. It is this credible commitment to privatization that weakens the force of the allegation of improper state aid. A commitment to privatize having been made, and a CEO having been charged with the task of bringing this about, the duty of the CEO becomes that of maximizing the value of the entity. One rather obvious implication of this duty to maximize value would be that the CEO should maximize the proceeds of the IPO and the subsequent tranches of equity to be sold.¹⁰

The state aid case and the cross-subsidy case have implications for the privatization of USPS. Currently, USPS is extremely restricted in its ability to enter other businesses and its rates are strictly scrutinized by interveners in cases before the Postal Rate Commission. If it were privatized, USPS would be at least twice the size of Deutsche Post and would almost certainly be subject to litigation on the grounds of improper state aid or using funds from its letter monopoly to enter competitive ventures. This would place the US government on the horns of a dilemma. Either it could keep USPS as a public enterprise, with perhaps some regulatory changes, or it could privatize it, but in such a restrictive manner that the value of the IPO would be severely affected. We now examine the privatization option for USPS.

The privatisation option for USPS

We first examined the privatization option for USPS in Crew and Kleindorfer (2000). We will start in this section by sketching this framework and then examine the feasibility of getting from here to there, to foreshadow our conclusion, 'You can't get there from here!'

In this section we will sketch a possible scenario for the future of a privatized postal service, the United States Postal Service, Inc. (USPSI).¹¹ We see USPSI as a continuing regulated monopoly, with details on proposed regulation below. However, we would propose reducing the monopoly from the current arrangement under which competitors cannot charge less than three dollars or twice the postage, whichever is greater, and 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 services and fixed network industries over the last 10 years or so. Indeed, the US postal service faced entry into its business at an early stage in the form of worksharing, namely discounts for pre-sorting. Unlike privately owned companies, it did little to oppose market entry in this form. Similarly, its parcels business was devoured by UPS and FEDEX, who came to dominate the courier service. Now postal administrations in Europe and the USA 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.

Entry by competitors in network industries has not been complete, as some part of the value chain is a natural monopoly. Some parts of the industry can be successfully subjected to competition, but there is a residual monopoly, bottleneck or essential facility. As was 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 approach we proposed was to pare down the residual monopoly to the bone 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 either a monetary limit or a weight limit. Increasingly, in Europe the trend is to move to a limit based upon weight, which varies from country to country, subject to an upper limit of 500 grams required by the EU. Many countries are operating significantly below this level. In addition, USPS has a mailbox monopoly, which means that other carriers delivering items are not allowed to put them in the receptacle provided for the sole use of USPS.¹² We would propose a new approach to the regulation of USPSI. We would argue that many of the upstream services such as collection, transport 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 supplier of services wholesale and would not have any retail customers. Under our proposal, USPSI would provide only the local delivery networks and the sorting 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 they do 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 weight limit. This weight limit would likely be less than the current limit.

The problem with this proposal, if this were the extent of it, 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 the 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 is an extremely low value item leaving very little scope for competitors to bundle the services.¹³ This is likely to be an even more important problem in rural areas, which receive service only because of cross subsidization from low-cost urban areas. These areas are highly vulnerable not only 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 POs. We are saying, in effect, that we cannot see much, if any, interest by new entrants 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 or reserved area 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, forms a large part of USPSI's 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 the target for this option would likely be USPSI's profitable customers; that is, 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, as analysed in Crew and Kleindorfer (1998).

In common with most privatization proposals, we would envisage that USPSI would be subject to a form of PCR. Again without going into details, it is clear that the choices are between pure price cap regulation and hybrid price cap regulation.¹⁴ 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. 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 takes a traditional cost of service approach based upon expected expenses and a rate of return on the invested capital or rate base.

The initial rate case is likely to be a highly contentious matter, in that USPSI would have every incentive to maximize the amount of expenses to be placed on the regulated sector. The aim would be to have a solid base of the reserved area on which to build, presumably with a view to pursuing a strategy similar to TPG, Deutsche Post and the massive Bell operating companies, all of whom were able to move into new businesses on the solid foundation of an underlying and relatively robust monopoly. In the case of USPSI, the current rate-making process is going to be stretched to the limit. Large numbers of interveners will oppose the expenses placed on the monopoly area. The potential for litigation will be huge, with protests of improper state aid and use of the monopoly along the lines faced by Deutsche Post, except that the protests will be much louder. It will be exceedingly difficult to reach agreement and to develop a funding package that will lead to a successful IPO. We will expand on this in the next section, but for the moment we will assume that the process is successful. With this heroic assumption, the rest of the process is relatively straightforward.

On the assumption that the initial rate case produced an allocation of

expenses, it would be possible, on the basis of this allocation, to 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.¹⁵ 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 consumer price index (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 in posts. 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 (see Chapter 23).

While, in principle, it is possible to design a regulatory scheme for a privatized USPSI not dissimilar to those employed in other network industries and for privatized POs, as we just noted, there are non-trivial problems to be addressed. However, when the details of the situation currently faced by USPS are examined, the situation looks much more serious, as we now discuss.

The way forward for USPS

Currently, USPS faces some very serious problems. It faces major competition from the Internet. It faces severe financial problems and institutional constraints that prevent it from controlling its most important factor of production, labour. Recently, added to these problems has been the recognition that USPS is also very vulnerable to terrorist activity. Together these difficulties raise serious questions about how to bring about a successful privatization of USPS, which we now examine.

As the recent use of the mail to deploy anthrax has highlighted, mail service is extremely vulnerable to terrorism, especially bioterrorism. However, even before this, its vulnerability to terrorism has been apparent. For a number of years it has restricted items that can be placed in public mail boxes to those weighing less than one pound unless affixed with machine postage. This meant that individuals and small businesses had no choice but to mail items above one pound through a postal counter. While this is a small inconvenience, it makes the product less valuable. Postal service is anonymous and low priced. Both of these features mean that individual pieces receive minimal attention on the part of mailers and on the part of POs. Terrorism takes advantage of these features, raising postal costs and making the product less valuable. The losses imposed by terrorism are likely to make the operation of USPS much less attractive to the private sector. Investors may be unwilling to take the risk at prices that are feasible.

The financial problems facing USPS are particularly severe, as described

by Robinson and Rawnsley (2002). The future looks even bleaker, as the situation has deteriorated rapidly since their study, due to both bioterrorism and a drop in postal volume. In addition, extra off-balance-sheet liabilities have come to light and there is reason to believe that the liabilities actually stated on the balance sheet may be understated significantly. Off-balance sheet liabilities have recently received worldwide interest with the Enron bankruptcy and the web of off-balance sheet transactions that in the case of Enron served to hide billions of dollars of losses and liabilities. In the case of the USPS accounts, the problem is also a serious one. Robinson and Rawnsley note a liability of US\$32.02bn for deferred retirement costs out of total assets reported of US \$59.09bn. Included in the latter figure is the former figure, which appears on both sides of the balance sheet! Thus, by an accounting fiction, USPS is solvent! This accounting fiction is quite legal for regulated companies and is in accordance with generally accepted accounting principles (GAAP). The idea is that the regulated monopoly will provide for the funding of these liabilities as they occur in the future.¹⁶ The ability of the letter monopoly to provide for this deferred liability is clearly called into question by the increased competition from the Internet and related forms of e-commerce.

Robinson and Rawnsley draw attention to off-balance sheet items that are of almost as serious a nature as the deferred pension obligations listed on the balance sheet. The most important of these off-balance sheet items is unfunded deferred retiree healthcare obligations. These are significant for USPS and for major US private sector companies. In the case of large private corporations, the treatment is the same as with USPS. For both they are treated as off-balance sheet items. Robinson and Rawnsley provide their estimate of the capitalized value of retiree healthcare liabilities of USPS at various discount rates, ranging from 5.5 per cent to 9 per cent. At the bottom end of this range the liability is around US\$27bn and at the upper end around US\$47bn. Given current interest rates, the 5.5 per cent discount rate may, if anything, be a little high. So, in some respects, US\$47bn might be considered a lower bound on liabilities.

These are serious financial problems that will be extremely difficult to overcome whether USPS continues as a public enterprise or is privatized. A decade ago the problems might have been manageable. USPS's unfunded liabilities would have been much less and the value of the monopoly would have been much more. If USPS had been subject to the kind of reform efforts undertaken in Germany at that time, the result might have been very different. Single piece postage rates, at least, would almost certainly have been higher and postal workers' wages might have been lower. Now privatization does not seem feasible without a major injection of funding from the US government, including a guarantee of the deferred retiree obliga-

tions accompanied by a large increase in rates. Such a package is likely to be opposed by strong forces.

The same pressure groups that prevented reform when the situation was more manageable still exist. Three major groups mean reform efforts are likely to flounder. Organized labour is concerned that a privatized USPS would pay lower wages and demand different work rules. Competitors are quite comfortable with a weak competitor like USPS, and they undoubtedly have an adverse effect through the current regulatory process on USPS's ability to price competitively. Under privatization and price caps they might face a competitor of the muscle of Deutsche Post and have to resort to more costly litigation in the courts as opposed to working through the regulatory process. The third group is mailers. Many businesses are built on the foundation of cheap but basic mail services provided by USPS. Opposition to major increases in rates is likely to be significant. All of these are powerful forces that will be overcome with great difficulty. It is not surprising, therefore, that reform efforts in the House of Representatives have not included privatization; however, they have included various forms of incentive regulation, though the residual claimant of a private firm would be absent.

Is there a scenario that might result in reform, a situation so severe that serious reform has to take place and might result in appropriate action being taken? This situation would need to be such that the pressure groups were overcome by a greater force. This is possible, but it has not yet happened. In the Spring of 2002, USPS is about to obtain a significant rate increase, though its revenues may not increase by the amounts that the forecasts predict. The seriousness of the situation may then be realized and real reform may take place. Possibly this should take the form of privatization. The benefits of this would be that the postal service would be less politicized and that labour relations would be changed significantly. A privatized postal service would, in such circumstances, be a much more powerful competitor. It would probably be a company similar to Deutsche Post with a range of operations not just confined to traditional mail. To satisfy its USO, it would presumably continue with some regulated monopoly protection. It would have powerful scale and scope economies and would be subject to complaints of unfair competition that do not exist under the present framework. It would, therefore, need to be subject to different competitive rules than a public enterprise and would have the potential of being more efficient than a public enterprise. But there are serious barriers to privatization, as we have noted.

Conclusions

Privatization in the postal arena could significantly improve static and dynamic efficiency relative to existing public enterprise. This is likely to be the

case with USPS. However, the reform process is currently highly politicized in the USA, resulting in the inefficiencies examined here and elsewhere. Moreover, the highly politicized nature of USPS means that there are huge barriers in the way of any significant change. The USO, slow technological change, severe financial problems and the presence of powerful pressure groups, consisting of labour, competitors and mailers, make meaningful reform, including privatization, extremely difficult. A big bang may be needed. Deteriorating finances and technological change may be sufficient to precipitate such a crisis fairly soon. Alternatively, current reform efforts before Congress plus a continued willingness to provide government support, particularly in the area of underfunding deferred retiree obligations, may make it possible to paper over the cracks and delay the crisis for a considerable period. During this period USPS will shrink and privatization, if it ultimately arrives, will involve a much smaller company.

Notes

1. Water utilities in the USA are mostly publicly owned but there is a trend towards privately managed operations through contracts with privately owned utilities.
2. Unfortunately, not all boards perform their fiduciary function very effectively, as the Enron bankruptcy indicates.
3. Cohen *et al.* (2002) argue that the burden of the USO is heavier in some countries than in others. In particular, they argue that Italy is at the heavier end of the spectrum, while the USPS is at the lighter end.
4. In electric utilities it is known as the default service obligation (DSO).
5. For a recent survey and critique of reform efforts in the postal sector, see Campbell (2001).
6. This is normally based on a price index, for example, the Laspeyres index, which allows the firm to set its prices within the limits of the index.
7. It is difficult to argue in a credible manner that taxpayers are meaningful residual claimants.
8. Under private ownership these issues might be at least as serious. The revised H.R. 22 recognized some of these problems. 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 non-competitive products. Given the common resources used to provide many of the most obvious competitive products, attempts at accounting separation will undoubtedly lead to many complexities and additional regulations to sort out what resources are used for various products and what cost responsibilities are to be assigned to these products. The potential for strategic behaviour to discourage entry exists in public enterprise, as a recently documented example of cross-subsidies of competitive products 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 non-competitive products if the USPS continues as a public enterprise.
9. In addition, it is difficult to introduce practices that might reduce cost, for example, more part-time workers.
10. Interestingly, in defending the case this argument did not figure prominently. A major argument employed was that there was no improper state aid because of Deutsche Post's obligation to finance the USO.
11. We are confining our attention to regulation of USPSI and will not discuss major open

- issues, such as finance and labour relations. See Froelke (2000) for some ideas on possible reform of postal labour relations as a prelude to 'privatization'.
12. Note that this is strictly a *mailbox* monopoly. It does not apply to residences with mail slots. Anyone is allowed to deliver if they can get their letter through the slot.
 13. Compared to an electricity bill, a stamp is an extremely low value item. However, in the case of residential electricity customers, absent subsidies, getting companies in the USA interested in supplying such customers has proved difficult.
 14. These terms are discussed in Crew and Kleindorfer (1996) and Kridel *et al.* (1996).
 15. The index would apply to each basket separately. For example, if USPSI chose to raise the price of 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.
 16. It is obviously a little more involved. The underlying principles are described in Robinson and Rawnsley (2002).

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