

DEVELOPING POLICIES FOR THE FUTURE OF THE UNITED STATES POSTAL SERVICE*

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The United States Postal Service currently faces a number of deep-seated problems that are not easily resolved. With these problems in mind, Postmaster General Jack Potter and Under Secretary of the Treasury Peter Fisher announced on December 11, 2002 the formation of the Presidential Commission on the United States Postal Service. In this paper we offer our contribution to the debate on the future of the USPS.¹ We argue that the current business model of the United States Postal Service has become increasingly out of step with reality. We review the background and current problems facing USPS and then draw a number of implications for the future of USPS.

The problems of USPS are deep-seated arising from a flawed business model as well as major secular changes involving the substitution of electronic media for physical media. The events of September 11, 2001 and the subsequent slowing of the economy have exacerbated these problems by causing losses of revenue and additional costs at a time when USPS was already facing considerable financial pressures. The essence of the matter is that USPS has an inefficient organizational and governance structure that precludes alignment of market developments and efficiency incentives with investments and operations. These issues are complicated by the fact that USPS has a Universal Service Obligation (USO), which is both a curse and a blessing, in that it is not only the source of significant costs but also provides the basis for legitimating its letter monopoly and other privileges.

The most important problem going forward for USPS is the pressure it faces in the form of competition from various electronic communication service providers. This has led to the erosion worldwide of demand for the basic letter-mail products of postal services, and this is anticipated to continue and possibly strengthen. Its current product mix is not well suited to problems it faces, especially those arising from the need to finance its obligations and to the market forces arising from the growth in e-commerce. USPS needs to change significantly the nature of its product mix that still relies heavily on its monopoly in letter mail, which is under pressure, while failing to take advantage of the opportunities for growth in many competitive products, including parcels, small packets and hybrid electronic mail products. In competing in these areas, it faces problems that arise not only from its own cost structure and regulatory cost allocation mechanisms, but also from the response such entry elicits from its competitors.

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¹ The Commission includes leading figures from industry, labor and the academy. It is holding a number of public hearings throughout the United States and has invited a number of witnesses to testify. See Crew (2003).

A major aspect of the institutional and governance structure of USPS arises from constraints on its flexibility in pricing and in the introduction of new products, as well as on the use of its primary input factor, labor. The nature of these institutional constraints significantly impairs its ability to respond efficiently to changing market conditions, including any such conditions requiring a smaller and more flexible labor force. Understandably, USPS has argued strongly for changes in regulation that will allow it to respond more flexibly to real or perceived competition. On the other side, there is concern about the market dominant position occupied by USPS and the potential it has for impeding competition by abusing this position, e.g., engaging in cross-subsidies or predatory pricing to impede entry. Under the present circumstances of eroding letter mail volumes and significant financial problems, it is especially difficult to determine what elements of USPS behavior are essential for the viability of the USO and what elements are unnecessary infringements on the market.

In the absence of institutional change, it is unlikely that USPS will achieve the significant cost reductions and service improvements required to remain competitive. As a government enterprise, the USPS lacks two key incentives for cost containment and service improvement: it has no profit incentive and is unable to go bankrupt. As a regulated enterprise, the USPS has little flexibility to alter its prices, introduce new services, or control its labor costs, which account for 80 percent of total costs. If the underlying causes of these problems are not addressed, competition could easily exacerbate USPS' financial difficulties, creating political pressure for massive taxpayer subsidies. USPS's (2002) *Transformation Plan* and the continuing debate on postal reform in Congress,² as we argued in Crew and Kleindorfer (2002c), do not come close to addressing the serious problems currently facing USPS and the likely worsening ones in the future. As noted above, the central issues facing the USPS of eroding demand, necessary financial restructuring, uncontrolled labor costs and the ways and means of meeting some appropriately structured Universal Service Obligation. As we make clear below, unless these central issues are addressed, the very survival of the USPS is in doubt. These are some of the critical issues facing the Presidential Commission that have previously been barely addressed.

The paper proceeds as follows. In section 1, we highlight some of the basic problems facing USPS. These problems are deeply rooted in the current financial status of USPS and its bleak prospects going forward. The source of USPS's problems are its flawed business model, which we examine in Section 2. Section 3 examines some of the possible reforms that the Presidential Commission might consider. Finally, Section 4 is by way of summary and conclusions.

1. Current Condition and Prospects of USPS

The fundamental flaws in the USPS business model are reflected in some of the very serious problems it currently faces. These include powerful competition from the

² H.R. 4970 – was rejected by the House Government Reform Committee on June 20 by a vote of 20 to 9. The bill was opposed by both United Parcel Service and the Teamsters Union.

Internet, severe financial problems and rigid institutional constraints that prevent it from controlling its most important factor of production, labor. As the recent use of the mail to deploy anthrax has highlighted, mail service is also extremely vulnerable to terrorism, especially bio-terrorism. 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 operation of USPS much less attractive to commercial mailers, given the increased scrutiny of their mailings.

All of these elements combine to yield a grim picture. The financial problems facing USPS are particularly severe. When Robinson and Rawnsley (2002) analyzed the finances of USPS they examined the 2001 Balance Sheet, which indicated an extremely serious situation. Since then the situation has improved with the discovery of that USPS had made contributions in excess of those considered actuarially appropriate resulting in the removal of a large liability from the balance sheet.³ However, significant off-balance-sheet liabilities remain. Off-balance-sheet liabilities and other accounting problems have recently received worldwide interest with the Enron bankruptcy and the web of off-balance-sheet transactions that in the case of Enron allegedly served to hide billions of dollars of losses and liabilities. Examination of USPS accounts also reveals similar serious problems, although in the case of USPS there is no reason to believe that any improprieties have taken place.⁴ Off-balance sheet obligations, however, were unaffected by this revelation. The most important of these off-balance-sheet items is unfunded deferred retiree health care obligations. These are significant for USPS and for many major U.S. private sector companies. In the case of large private corporations, the treatment is the same as with USPS. They are both off-balance-sheet items. Robinson and Rawnsley provide their estimate of the capitalized value of retiree health care liabilities of USPS at various discount rates ranging from 5.5% to 9%. At the bottom end of this range, the liability is around \$27 billion and at the upper end around \$47 billion. Given current interest rates, the 5.5% discount rate may, if anything, be a little high. So, in some respects, \$47 billion might be considered a lower bound on these retiree health care liabilities alone.

These facts strongly underline the importance of promoting accounting transparency for USPS, so that at least the full extent of the “costs” of postal service are recognized as we

³ On November 5, 2002 Postmaster General John E. Potter made an announcement to the Board of Governors of USPS to the effect that a new financial analysis of the Postal Service portion of the federal government's retirement fund disclosed that postal payments have almost fully funded all future retirement obligations for its employees and retirees enrolled in the Civil Service Retirement System (CSRS). A financial analysis was made by actuaries and others at the Office of Personnel Management (OPM) and validated by subsequent Office of Management and Budget (OMB) and Department of Treasury reviews showing that the shortfall was now only \$5.

⁴ Given the absence of residual claimants incentives for the kind of manipulation alleged in the Enron case would not be present. The deficiencies in USPS accounting may stem from failures in accounting generally and from the failure on the part of the government to address USPS's problems in a credible manner.

go.⁵ The deferred liabilities noted above are but one of several problems facing USPS that threaten to undermine its very future. As a private enterprise, it is unlikely, unless there were fraud of the scale allegedly perpetrated by Enron, WorldCom and other worthies, that USPS would have been able to get into its current financial state with liabilities in the region of \$32-52 billion in excess of its assets.⁶ As a public enterprise it can still continue without radical restructuring. However, as a public enterprise, USPS faces significant barriers to such restructuring, of which the USO and labor costs are the predominant issues, which we discuss in greater detail below.

Can USPS use its letter monopoly to provide the funding for its deferred liabilities and off-balance sheet obligations? This seems unlikely, since increased competition for its basic letter-mail product will undoubtedly continue. For example, the ever-increasing penetration of the Internet alone is having significant impacts in eroding bill presentment and payment procedures via postal services. Partly reflecting such increased choice in the market place, estimates of letter-mail demand elasticities in recent studies have been near unity or greater, and estimates of letter-mail volumes and revenues suggest the strong likelihood that these are already in decline.⁷ For example, Robinson (2002) notes that First Class Single Piece Mail, the primary product in USPS Retail Sector, has seen annual volumes between 1991 and 2002 decrease from 15.1 to 13.3 billion pieces. Most of this is the result of electronic diversion of business mail. In the Commercial Sector (which includes all mail that is tendered to USPS in bulk), USPS revenue has shown steady increases throughout the period 1972-2000, but sharp declines in the past two years, perhaps as a result of recession and terrorism. Even if commercial revenues recover somewhat, however, demand estimates in the industry make it very difficult to imagine a scenario that will enable USPS to use its letter monopoly to provide funding for these deferred liabilities. Indeed, given its operating losses in the past two years and the demand issues noted above, if USPS does not become considerably more adaptive in its approach to managing its labor costs and fixed facilities, it might not even be able to meet its operating costs going forward. The recent report by the General Accounting Office (2002) underlines the seriousness of the current and prospective USPS financial situation.

⁵ The accounting transparency issue is a “disclosure issue” and not a managerial issue, in the sense that regulators should not have to dictate to USPS how to perform its internal accounting. Rather, the incentives they face through regulation and institutional changes should cause them to want to know true costs and true cost drivers on their own.

⁶ This is an estimate obtained by taking the figures of \$27-47 billion for retiree health care, and adding \$5 billion for the revised pension liability. It is possible that some of the assets may be undervalued, notably, real estate. However, it would be hard to envision this accounting for more than a few billion and nothing close to the suggested likely magnitude of the retiree health care benefit deficit.

⁷ Wolak (1997) provides elasticity estimates for the household sector in the U.S. that show a clear pattern of increase, beginning in the early 1990s, achieving levels well above unity by the mid 1990s. Similar patterns to those in the U.S. are reflected in studies on other postal administrations as well. All of these show the significant impact of electronic communications in eroding letter mail volumes and in putting pressure on postal administration revenues. For a recent summary, see Florens et al. (2002).

The basic problem faced by USPS in controlling cost arises because of the fixed nature of costs arising out of its USO, as illustrated in Table 2 (from Cohen et al. (2002)). This Table provides a breakdown of the cost structure of USPS between fixed and variable costs. From this we note that delivery and window services are overwhelmingly fixed, running over 50% of their total cost. This reflects the basic problem of the USO, in that Post offices and ubiquitous delivery are the major elements of the USO. As long as the USO continues in anything like its present form, there will be a significant fixed cost element to it with all the attendant pricing and entry regulation problems.

Table 2: USPS Fixed/Variable Cost by Major Function (FY 1999)

Source: Postal Rate Commission Docket No. R2000-1

Function	Fixed (%)	Variable (%)	Total Cost (\$ Billions)
Delivery*	52	48	22.1
Mail Processing	4	96	21.4
Transportation	8	92	4.3
Window Service	54	46	3.1
Other	77	23	11.5
Total	37	63	62.4

*Delivery includes in-office and out-of-office costs.

The most salient feature of USPS cost structure, as with other postal administrations, is the fundamental role that labor plays in determining total costs. In recent years, the cost of labor has held steady at approximately 80% of total USPS costs. As discussed in detail by Wachter et al. (1991, 2001), labor inflexibility and wage levels have a major effect on the ability of USPS to restructure its operations to remain viable. This is very important for any discussion of the future of USPS. USPS labor agreements with postal unions leave very little room for postal management to control labor costs, as these are determined by an external arbitration process. Over the years, this process has led to a wage premium in excess of 20% relative to comparable wage standards in the private sector.⁸ Thus, given current wage premium levels, full-time USPS employees, currently around 800,000, have little reason to seek employment elsewhere. This, and job security provisions included in postal labor agreements, make it exceedingly difficult under present arrangements for postal management to respond flexibly to competitive or market pressures that dictate changes in the structure or size of the postal labor force. These are serious financial problems that will be extremely difficult to overcome whether USPS continues as a public enterprise or, as recommended by some, is privatized. A decade ago the problems may have been manageable. USPS's unfunded liabilities would have been much less and the value of the monopoly would have been much more. However, the current situation is much bleaker. USPS has huge retiree liabilities; and it faces increasingly elastic demand, severe competition and uncontrolled labor costs that make

⁸ In addition, Wachter et al. (2001) provides the results of further assessments and comparisons, taking into account working conditions between postal workers and various private sector counterparts, showing that the wage premium may be as high as 36.2%.

up 80% of its current total cost. The remedies available to the private sector of downsizing and restructuring face insuperable barriers given the governance and ownership structure of USPS. The discipline of competition and resulting incentives for innovation can only have muffled effects under these circumstances.

2. The Fundamentally Flawed Business Model

The serious problems currently facing USPS arise primary from its out-moded business model. We examine four basic attributes of a viable business model that are deficient in varying degrees in USPS. First, there should be a governance structure that attracts highly qualified top management, mainly by providing an appropriate incentive and reward structure. Second, there should be freedom to introduce new products or services without undue delay for regulatory clearance. Third, management should be able to control its principal input costs, which, in the case of postal service, is labor. Fourth, the regulatory framework should allow for growth or change while preserving the Universal Service Obligation (USO) and offering some protection for small customers. These features are not controversial. For regulated industries generally, any viable business model would be expected to have these features. USPS is deficient in varying degrees in these four attributes as outlined below.

The current business model for USPS lacks at least four principal attributes of a viable business model.

Ability to Attract Highly Qualified Top Management

USPS has a salary cap for its top management equivalent to the Civil Service salary cap. This salary cap may work well in the Civil Service but it does not work well at USPS. Despite the salary cap, the Federal Government seems to be able to attract many of the ablest lawyers, economists and managers. The Federal Trade Commission, the Department of Justice, the Federal Communications Commission, the Treasury and so on are very attractive to ambitious economists, lawyers and others who hold high level positions outside government, because they offer very interesting and challenging work, with the opportunity to improve one's skills. In addition, although the majority of such individuals take significant cuts in monetary compensation, it is seen in their minds as an investment in their human capital. With the experience and contacts gained they expect and usually obtain a high return for their time in government. Looked at in these terms high-level government service is not badly compensated since it offers interesting work and valuable experience that likely results in a significant increase in future earnings. By contrast USPS has little to offer to such talented individuals. It can offer similar monetary compensation to other government posts, but it does not offer great prospects. Few talented individuals would be convinced that an assignment of a few years at USPS would enhance their human capital and therefore future earnings. One reason for this is that there is not the opportunity to have an impact on decision-making and policy that other government jobs provide. The problem is that USPS is a business but it is not run like one. The experience gained is not likely in most cases to be transferable to other

businesses. It is not even likely to be very transferable to other post offices in the world, as these have, for the most part, a national character of their own that is not congenial to cross-cultural management transfers. USPS is not a source of managerial or professional talent for GE, IBM, Wal-Mart or other successful models of large business.

The combination of inadequate compensation, work that is unchallenging relative to the alternatives, and a lack of prospects mean that USPS is unable to attract the top business men and women who have the ability to make it into the successful business it is capable of becoming.

Freedom to Introduce New Products and Services

Successful businesses cannot rest on their laurels. Technology and the business environment do not stand still. Products that were great a few years ago get pushed aside as tastes and technology impact the market place. USPS faces considerable regulatory and other obstacles when it attempts to be innovative. This is not to argue that USPS should be allowed to diversify into all kinds of vaguely related businesses. As long as it is a public enterprise, it is expected to confine itself to mail and very closely related products. However, it must recognize the trends that are taking place around it. USPS is part of the communication business, which has undergone dramatic change because of advances in microelectronics and optical fiber apparent in *inter alia* the ubiquity of the Internet and wireless telephony. USPS's traditional high margin products, notably First Class Mail, face severe threats. They cannot be counted on anymore to bail USPS out of its financial difficulties. USPS needs to develop a better understanding of the link between the new electronic technologies and its business. This includes an increased ability to track and trace its products and the introduction of more hybrid mail products. It may mean introducing new parcel and small packet delivery services that compete with the major parcel delivery services. The current regulatory process delays USPS in introducing new products and is employed by competitors to influence USPS pricing of such new products.

Cost Controls

Just as a business controls its revenues by product innovation, marketing and advertising, it also has to maintain control of its costs. Around eighty percent of USPS costs are labor and it has exceedingly limited control of these costs. The compensation of its unionized employees is not subject to traditional collective bargaining as practiced in private industry but "interest arbitration."⁹ Postal employees do not have the right to strike but in the event of a failure of their union and USPS to reach an agreement they take their case to binding arbitration. Thus, an outsider, an arbitrator, determines USPS principal input, wages. Over the years, this process has led to a wage premium in excess of 20% relative to comparable wage standards in the private sector. In addition, USPS has nationwide uniform wages, making postal work exceedingly rewarding in some low wage parts of the U.S. economy and making it difficult to hire in high wage areas. Thus, for its

⁹ Sauber (2002) provides not only a useful description of the process but espouses a contrary view to the one argued here.

significant premium USPS does not get much benefit, one sign of which is its continuing problems with labor relations as evidenced by large numbers of grievances. Postal labor makes its views clear to Congress, finding many ears willing to listen on Capitol Hill. All this means that USPS has very little control of its labor costs and faces significant obstacles in achieving productivity improvements.

The incentive structure facing management at USPS not only makes recruitment of top managerial personnel difficult but also it does not encourage or promote cost controls. Top management in private enterprise has a powerful incentive to control cost because of the impact of cost control on the bottom lines. Lower costs imply higher profits and usually higher compensation for management. For USPS no such incentives apply. Top management gets effectively the same compensation whether or not costs are reduced. Indeed, for top management making hard decisions to reduce costs is more likely to result not in rewards but in conflict. Given the high percentage of labor costs, significant reductions in costs will involve cutting labor. This will present top management not only with problems from postal unions but also from the representatives in Congress. The recent improvements in efficiency and cost reduction under current postal management are especially laudable given the incentives faced by management.

While its ability to control its labor costs as a result of the peculiarities of collective bargaining process and the incentives faced by postal management is a major problem, there are other forces at work that are detrimental to the control of its costs. In particular, the level and nature of the oversight exercised by Congress on USPS activities is problematic and needs to be changed. Clearly, Congress has an interest in assuring the continuing provision of the USO (discussed below), in providing some protection to consumers, and in assuring that USPS does not exploit any market dominant position it may have. However, such oversight needs to be an arms length rather than Congress taking a more interventionist role. For example, Members of Congress may see considerable benefits in terms of jobs in having a Federal facility, be it a military base, a penitentiary or a mail processing facility in their districts. However, to the extent that Congress directly influences operating or facility closure policies, the ability of USPS management to assure a viable business model for USPS could be slowed up and ultimately compromised. The result would be that USPS operations would be higher cost than they would be if such decisions were made on a commercial basis. Thus, there needs to be a rebalancing of the required autonomy and discretion for USPS management to achieve commercial operations with the information and oversight that Congress should have to assure itself that the national postal infrastructure is viable.

Regulatory Framework and the USO

USPS faces a major burden in terms of the universal service obligation (USO). This is the obligation to provide ubiquitous service at a uniform price and at a reasonably uniform standard of quality. Quality standards allow some flexibility but the other features of the USO do not. The USO is a major burden on USPS and most POs worldwide. It is basically an obligation to provide extensive cross subsidies between high cost and low cost routes or areas. Absent regulator intervention, a private company

could not sustain such an obligation because competitors would undercut it in the low cost areas and routes, leaving it with no margin to support its high cost areas. One role of the regulatory framework is to administer the USO by adjudicating the rights of customers and competitors while safeguarding the obligation to serve. In effect the regulator administers a regulatory contract. Such a process has to balance the rights of the various parties involved.

While it operates within a framework of law, the Postal Rate Commission (PRC) has a significant role in interpreting and administering the regulatory process. Its mandate cannot be specified in every detail. PRC has considerable discretion in interpreting testimony from interveners. Depending on the views of the membership of the PRC, the treatment that competitors or particular customer groups receive can vary significantly as the PRC has extremely detailed rate setting authority. While its decisions are technically “recommended” they are not easily overturned by USPS management operating through its Board of Governors. In a number of ways, especially the lengthy and cumbersome rate case proceedings, the regulatory process inhibits significantly USPS ability to set prices. Similarly, on the issue of closure of post offices the hearing process administered by the PRC places non-trivial restrictions and delays in closing local post offices.

3. Strategies for Reform

Postal service has a number of features that make it distinct, both in its historical evolution as well as in the challenges facing the sector going forward. No feature is more important in the debate on the future of USPS than the USO as it provides justification for other policies that effectively diminish competition in the name of assuring the PO the financial wherewithal to provide the USO. Any reform strategies for USPS must address the USO. While we do not examine the USO in detail, as we have done so at length on many occasions, for example, Crew and Kleindorfer (2002d), we expect that all reforms would include a continuing USO. By this we mean ubiquitous service at a uniform price and a reasonably uniform service standard. The importance of uniform price needs to be underlined. Without it there would be no effective USO as either rates would be cost based or the PO could choke off demand in high cost areas by setting a prohibitively high price. Given that the abandonment of the USO is not on the table the issues that remain are what changes could be made to increase efficiency. The changes could include changing service standards, for example, delivery five days a week rather than six and different methods of funding the USO.

On funding the USO there are a number of views. They include Cohen, Ferguson, Waller, and Xenakis (1999), Sappington and Sidak (2001) and Postcomm, the British regulator, implying that the USO carries with it certain benefits that make the USO effectively self-funding. In our view, *a priori*, there is no basis for such an argument as

long as high cost routes exist. Empirically, it would be necessary to show that high cost routes are of minimal significance (e.g., Cohen et al. (1999, 2000, 2002)). This is an interesting hypothesis but would require more testing and may be highly sensitive to the methodology employed. Hence, we will pursue the traditional approach that the USO is not called an obligation for no reason and that a funding issue exists. Reform will therefore have to provide a funding mechanism for the USO.

The USO is usually financed through cross subsidy from low cost routes to high cost routes. Although cross subsidy is not the only means of subsidizing high cost routes, as discussed in Crew and Kleindorfer (2000), it has traditionally been the only means used in almost all instances. The approach has been to fund the USO by means of a reserved area that allowed uniform pricing for standard products like letter mail without the threat of the cream skimming that normally attends uniform pricing. Thus, when faced with liberalization, POs have naturally been concerned about funding their USO.

The particular problem with providing detailed and credible econometric estimates of cost of the USO under competitive entry is that it is difficult to estimate the cost function of USPS under conditions and under institutional regimes where it has not operated to date. This leaves the field largely to theorists, and here both sides of the issue have found support for their arguments. On the one side are economists drawing inspiration from other industries. They note that competition may provide the stimulus for innovation and cost reduction. Such influences would tend to reduce the cost of the USO under competition. On the other hand, postal services appear to involve significant economies of scale and scope, which raises the possibility that competitive entry could be inefficient by eroding the incumbent's economies of scale and scope. Whatever is done to mitigate the current burden of the USO, the remaining costs, if any, must be funded either through an appropriate definition of the reserved service area (RSA) or through other funding. Such funding can arise either through external financing or through profits generated from competitive services.

External financing to fund the USO could be provided to the incumbent to help support service to the high cost areas. Several approaches have been analyzed in Crew and Kleindorfer (2000) for this funding, including explicit subsidies from general tax revenues and excise taxes placed on entrants' postal revenues. These all face various problems, not least of which are the inefficiencies that are typically triggered in incumbents when they are subsidized. POs, instead of attempting to attain efficiencies from more innovative operations and service offerings, would devote significant resources to protecting and increasing the subsidy. Funding such a subsidy is likely to be difficult and to impose further deadweight losses on the economy through the tax system. For example, one source for the subsidy could be an excise tax on selected postal and courier products. However, this is likely to work to the disadvantage of all, including competitors and consumers, will generate high transaction costs in tracking and monitoring the selected products to collect the tax, and will provide fertile ground for rent seeking.

Funding the USO by a specific subsidy levied on all firms in the industry is therefore likely to be an even greater problem than funding it through an RSA. The case against

specific subsidies is further weakened when, as argued in Crew and Kleindorfer (2002a, d), it may be possible to reduce the extent of the reserved area and allow greater access to the PO network. Innovative pricing and product development would be part of a package designed to broaden USPS funding base by greater reliance on parcels, small packets and other products arising from the Internet. This may involve not only new end-to-end hybrid products but also innovative offerings of access for parcels for other carriers. The reserved area envisaged would be extremely small being confined to single piece mail with a low monetary limit.¹⁰ While this approach requires additional development and testing, it may offer the prospect of opening up postal markets to more competition while maintaining a USO. However, these kind of reforms in the definition and funding of the USO, changes in access arrangements, innovative pricing and increased reliance on parcels and internet based products are likely to be inconsequential if the governance of USPS is not reformed.

The problem is that the benefits obtained from such reforms can only go so far if there are no significant changes in the public enterprise status or the governance structure. The reforms likely to promote a viable business model would need to address the regulatory framework, the labor relations framework and the governance of USPS. Governance might be considered the prime driver, as without changes in it the impact of changes in the other two is likely to be limited. The general idea is that USPS should become more commercial in its orientation. This could be achieved in varying degrees from increased corporatization and commercialization to privatization or ownership by the private sector. Commercialization implies that USPS would function similar to a private company although the stock would be held by the Federal Government. A commercialized USPS would expect to be subject to the control of its board of directors as in the case of a privately owned company and not directly subject to Congressional intervention as presently. To bring about successful commercialization would require a significant reduction in the role of Congress. This would be difficult to achieve short of privatization, but, whatever the ultimate institutional form USPS takes, every effort must be made to achieve commercialized operations if USPS is to have the necessary flexibility and structure to accomplish the business and policy objectives noted earlier.

Board of Directors and Profit Orientation

What is clear is that USPS needs to become much more commercially oriented and independent of government. A number of steps could be taken to increase the commercial orientation of USPS. These would include replacing the existing Board of Governors with a Board of Directors. As such it would resemble the Board of many large corporations, including leading figures from the business world. This would give the new USPS a profit orientation. Having a private sector style Board of Directors would have little impact unless USPS were allowed in certain basic ways to behave like a commercial entity. This would not be feasible unless the prohibition on retained earnings were repealed. This change along with a Board of Directors would make motivation and

¹⁰ The notion of Delivery-Area Access Pricing (DAP) proposed promotes downstream access, especially drop shipment to delivery offices and provides public tariff that varies according the costs of the delivery area with the highest rate being the single piece rate

compensation of top management less difficult. Profit orientation and ability to retain earnings would give the additional benefit, if successful, of putting USPS finances on a sounder footing. This would make USPS less vulnerable to Congressional intervention in its business. It would have the most basic independence of all, financial independence. Since Congress would not be paying the piper, it would find it more difficult to call the tune. The Federal Reserve has been successful in maintaining independence from both the legislative and executive branches of government because it has no difficulty funding its activities and even in effect paying a dividend to the Treasury. Ending the prohibition on retained earnings would go some way to giving USPS the desired commercial orientation and independence from government.

Compensation, Incentives and Working Conditions of Top Management

USPS needs to attract talented top management and commercialization would go a long way to achieving this in that it would involve a change of duties, different incentives and higher compensation, and the ability to make a difference in the future of USPS. One consequence of commercialization is that USPS would become more involved in the “selling business”. It would have to compete and become more innovation oriented. Of at least as much importance there are many other aspects of commercialization and “turnaround” operations that are well known in the private sector and could be brought by knowledgeable executives to USPS, if it were restructured to promote a culture of commercialization.

Labor and Other Cost Controls

Detailed discussion of labor reforms are beyond the scope of this paper. A commercialized entity would presumably have to make major changes in the existing system including allowing the right to strike and negotiating more productivity oriented labor agreements. Other possibilities might include an employee stock ownership plan (ESOP). Commercialization would involve a radical examination of all of USPS real estate holdings and product facilities and would presumably result in a major rationalization. This could result in the reduction in many mail processing positions and closure of facilities. Of course, such restructuring would have to be accomplished according to agreed principles and prior discussion with the public or its representatives, but a commercial orientation would leave the actual execution of rationalization strategies in the hands of USPS management.

Regulation

A commercial orientation would require a change in the regulation of USPS. Traditionally, postal regulation has provided a forum for special interests to battle over the division of the spoils. First Class Mail has traditionally been the captive mail product that has provided most of the contribution to fixed costs while other classes of mailers have fought to minimize the amounts they pay for advertising, newspaper, magazines and other products. USPS attempts to make headway in parcels and small packets have been

“policed” carefully by competitors who have intervened actively in the regulatory process. Regulation would change significantly not only in allowing USPS greater freedom but also the regulatory commission would no longer be subject to being overruled by the Board of Governors with its replacement by a Board of Directors.

Currently, the most of the Postal Rate Commission’s and USPS’s efforts are taken up with Rate Cases, which occur approximately every three years and formally take ten months to complete but in practice involve more time given the requirement that USPS and others prepare testimony. Formal rate hearings would be less frequent and much simpler under the new regulatory regime. Indeed, not all of USPS products would be regulated. Probably some form of price cap regulation, although not completely free of problems as we argue in Crew and Kleindorfer (2003), would be the most appropriate form of regulation. One major issue would be what to include in the price cap. Clearly single piece First Class Mail would be subject to regulation. One possibility might be to make single piece subject to a price cap with automatic adjustments according to an inflation index with all other products not subject to price regulation. While this seems to be minimal regulation, it turns out that regulating single piece would impact many other rates. For example, as argued in Crew and Kleindorfer (1994) this would set a ceiling on the access prices USPS could charge and would provide the base for presort and other quantity discounts. USPS might be required to file an access tariff for letters and parcels. Another possibility might require USPS to face a price cap on single piece parcels and small packets.

While the details of the regulation are beyond the scope of this paper and could be the subject of many more papers in the future, it is clear that regulation should not place a significant brake on USPS ability to price flexibly and introduce new products. Regulation would play less of a role in price setting but would take on an increased role in quality setting. In addition, the regulatory commission would like regulatory commissions in other network industries take on a greater role in refereeing disputes between USPS and other players in the postal market. This market is expected to become increasingly competitive thereby potentially reducing the need for regulation. In addition, with commercial freedom USPS could face not only action before the regulatory commission but also complaints under antitrust laws.

Commercialization or Privatization

How the commercialized USPS envisaged would differ from a privatization USPS deserves some consideration. Germany and the Netherlands both began with commercialization and have still not attained full privatization. Other successful experiments in commercialization, for example, Sweden, New Zealand, Canada and Australia, show no apparent interest in privatization. Experience in other countries where governance structures have been changed suggests some of the problems facing USPS might be responsive to major changes in governance. The experience of the Netherlands and Germany where significant progress toward complete privatization has been made could, if applied to USPS, overcome some of the major inefficiencies arising from the current governance structure. We will review this briefly.

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% of its shares in KPN, the combined postal and telecommunications operator, and in 1996 another 25%, making it a minority stockholder. In 1996 it 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 U.K. 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 130,000 employees and with revenues of almost 10 billion euros, 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 favorable treatment in its reserved area. The weight limit 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 extremely over-manned 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 to private investors 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 was achieved in a number of ways. The internal organization was transformed by changing 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 32.4 billion euros in 2000 and total employment in excess of 300,000, 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 and it will face many more 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 allege 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 March 20, 2001, the ruling 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. The German experience illustrates some of the tensions arising when moving from a state enterprise to a privatized enterprise, as illustrated by another case involving alleged state aid in providing the basic assets of the enterprise.

4. Conclusions: getting from here to there?

The success of commercialization, for example, in the case of Germany, the Netherlands, Sweden, New Zealand, Canada and Australia provide a strong case for the commercialization of USPS. The progress toward privatization in Germany and the Netherlands strengthen the case for going further, namely, adopting privatization. The issue is not only whether to privatize or to commercialize without privatization but also how to get from here to there.

As we have argued elsewhere privatization holds many advantages. Residual claimants are absent without privatization and residual claimants are powerful drivers under price cap regulation or market discipline of X-efficiency. Commercialization alone would not subject USPS fully to the discipline of the markets. Absent residual claimants it would not face the discipline of the capital market. This does not just mean the discipline of bankruptcy¹¹ but also the discipline of takeover. Residual claimants own their interest and can sell it. With well functioning capital markets this puts pressure on management. In addition to lacking residual claimant a publicly owned but commercialized USPS would still likely be subject to undue influence by government. The United States does not have a strong tradition of public enterprise, with the exception of water and public power, but does have a strong tradition of corporate private ownership. With this background commercialization seems distinctly unlikely to unleash the ingenuity of top managers in a manner needed to make USPS a successful commercial enterprise. Privatization is likely to be much more effective than public enterprise to succeed in this respect. However, getting to privatization might be difficult. Some steps would need to be taken including placing USPS on a sounder financial footing. All pensions and retiree health care responsibilities prior to the date of privatization should be taken over by the US government. The pension obligation would be in principle relatively simple to calculate but the health care obligation would be more difficult and it may be difficult to avoid some inequities in making such a calculation. One thing is clear, however, and that is that if a newly privatized or commercialized entity is burdened with the legacy of these pension and healthcare obligations its attractiveness to investors and its future viability will be adversely affected.

¹¹ At the hearing on February 20, 2003 the question of whether a privatized USPS would be allowed to go bankrupt was raised by the Commission.

The approach we would propose then is that USPS be set up similarly to a private corporation with a Board of Directors with the announcement that it will be privatized within a relatively short period, say 3-5 years. The CEO and the Board would be given the charge of working toward this end. The intent would be to reorganize so that the value of the IPO were maximized. This would involve all of the familiar strategies, downsizing some parts of the business, sale of assets, developing new products and possibly acquisition. Deutsche Post pursued and continues to pursue all of these strategies

Despite recent problems with private governance with instances of outrageous corporate greed and fraud, we continue to have faith in the corporate private ownership model. It has stood the test of time. Failure to consider privatization to replace USPS failed business model because of concerns with private governance is akin to throwing the baby out with the bath water. As indicated in Crew and Kleindorfer (2003) privatization of the USPS is likely to offer the prospect of the most efficient solution, with the privatized entity subject to restructured regulation to promote innovation and productivity growth. However, given the weak economy and experience elsewhere, getting from here to there is a challenge. Germany and the Netherlands both began with commercialization and have still not attained full privatization. Other successful experiments in commercialization, for example, Sweden, New Zealand, Canada and Australia, show no apparent interest in privatization. Even when privatization is the ultimate objective, experience may show that a more gradual commercialization approach may be superior to a big bang.

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