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***RETURN TO SENDER:  
REFORMS FOR THE FAILING POSTAL SERVICE***

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## **I. Introduction**

The U.S. Postal Service is facing a fiscal crisis. The demand for its core activity of mail delivery has collapsed, and further declines are likely. Mail has fallen over 20 percent since its 2006 high, a drop not seen since the Great Depression. First-class mail - by far the Postal Service's most profitable - is down almost 25 percent since its 2001 peak, and declines are accelerating.<sup>2</sup> As a result, revenue in real dollar terms has fallen over 15 percent since peaking in 2007. Increasing use of substitutes for physical mail, including email, cell phones, electronic document delivery, e-bill pay, online banking, and internet advertising, are all eating away at traditional mail volumes.

In the face of weak demand from such a powerful alternative, a typical business would rapidly downsize and reduce costs in a bid to maintain profitability. Indeed, the Postal Service has made progress in reducing the total number of employees over the past decade, which is critical as labor accounts for about 80 percent of its overall costs.<sup>3</sup> However, since 2006 those reductions have not been sufficient to allow the Postal Service to meet its legally required break-even constraint. Although it announced its desire to reduce delivery days, streamline its far-flung sorting and transportation network, and close under-utilized post offices to further reduce costs, it has been hobbled by political opposition to downsizing. As a result, the Service expects to lose between \$9 and \$10 billion for its 2011 fiscal year, on top of losses of \$8.4 billion in 2010. It was unable to meet a \$5.5 billion payment to the U.S. Treasury due on September 30<sup>th</sup>, which Congress deferred until November 18th. The Postal Service has exhausted all of its \$15 billion borrowing capacity from the U.S. Treasury, and is expected to run out of cash in the middle of 2012.

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<sup>2</sup> The Postal Services earns about three times the profit on each piece of first-class mail as it earns on each piece of standard mail.

<sup>3</sup> The number of total career employees fell from a high of about 798,000 in 1999 to about 584,000 in 2010, a decline of almost 27 percent.

Washington's refusal to allow the necessary cost-side adjustments to demand-driven market realities is at the core of the Postal Service's problems.<sup>4</sup> However, as long as the fundamental government-owned, legally enforced monopoly structure remains, there is no credible way of eliminating, or even substantially reducing, governmental interference with postal managerial decisions. The current independent government agency structure of the Postal Service was, in part, designed to reduce political interference, such as in the selection of postmasters.<sup>5</sup> As long as the Postal Service receives governmentally bestowed benefits and protections (e.g. exemption from paying corporate or property taxes) Congress will attempt to realize a return on those benefits by interfering with decisions about delivery days per week, sorting center closure, contracting of window services, and many others. Even if a (still) more "independent" structure could be designed for a government-owned postal service, its business decisions would likely become politicized over time.

Given the Postal Service's fiscal crisis, and the need to adjust to market realities, it is time to put the Service on a course toward meaningful structural change that will give it the ability to adjust to demand for its core activity of delivering physical mail. In this Policy Brief, I

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<sup>4</sup> Commentators agree that this is the source of the Postal Service's fiscal problems. AS the General Accountability Office (2010, p. 6) states, "USPS's business model is not viable due to its inability to reduce costs sufficiently in response to continuing declines in mail volume and revenue." As postal expert A. Lee Fritschler stated in 2009:

In essence, what the Postal Service needs is to be free of congressional interventions and allowed to operate as a regulated corporation in a competitive delivery services industry. Ever since 1970, when it was created by Congress to succeed the old Post Office Department, Congress has said it wants the Service to operate like a business. Yet ever since 1970, whenever attempts are made to respond to that mandate, some old congressional hobby horses ride forth and intervene.

A. Lee Fritschler, "Liberating the Postal Service," *Huffington Post*, May, 20, 2009, available at: [http://www.huffingtonpost.com/a-lee-fritschler/liberating-the-postal-ser\\_b\\_206037.html?view=print](http://www.huffingtonpost.com/a-lee-fritschler/liberating-the-postal-ser_b_206037.html?view=print) (accessed October 30, 2011).

<sup>5</sup> See R. Geddes, *Saving the Mail: How to Solve the Problems of the U.S. Postal Service* (Washington DC: AEI Press, 2003), p. 8-9.

lay out a plan for the development of a truly de-politicized Postal Service through de-monopolization, corporatization, and eventual privatization. I borrow from lessons learned in other countries that have reformed their postal services. I also describe how one of the most salutary and powerful economic forces – competition – can be brought to bear in subsidizing physical mail delivery on certain routes, should Congress decide that such subsidies are socially desirable. This approach will ensure that such subsidies are transparent and provided at least cost. Before addressing those issues, however, I discuss the Postal Service’s fiscal challenges in more detail.

## **II. The Decline in Mail Demand and Economies of Scale**

The Postal Service is facing the toughest challenges since it was created in 1970 through the Postal Reorganization Act. There is a single, immutable driver behind those challenges: the rising use of electronic communications that provide a cheaper, faster substitute to physical mail delivery.

The growing use of this potent substitute is rapidly eating away at postal volumes and revenues.<sup>6</sup> Figure 1 in the appendix displays overall mail volume from 1970 through 2010. Mail volume grew steadily from the mid-1970s through 2000 but has been unsteady or declining since.<sup>7</sup> Recent rates of declines are truly startling, such as the 4.5 percent drop in 2008, and the 12.8 percent decline in 2009.

First-class mail volume is displayed in Figure 2, and shows an even steadier decline over the past decade. First-class volume has risen in only one year since 2001: an anemic 0.148

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<sup>6</sup> The simple correlation since 1970 between nominal operating revenue and overall mail volume is 0.972, while the correlation between first-class mail volume and operating revenue is 0.926. These correlations are very high, indicating that falling mail volume is driving revenue decreases. Further reductions in overall mail volume are likely to result in similar revenue declines.

<sup>7</sup> Steady, stable growth in mail demand has long been a hallmark of the Postal Service. However, the growth rate in overall volume has become much more variable over the past decade. From 1970 to 1999 the standard deviation of the percentage growth rate in overall mail volume was 2.38. For 2000 through 2010 that standard deviation rose to 4.48. Six of those ten years exhibited declines in overall volume. This is consistent with a changing market dynamic.

percent in 2005. The data since 2005 suggest that first-class volume is declining at an increasing rate. The profitability of first-class mail makes this particularly disconcerting.<sup>8</sup>

Figures 1 and 2 suggest another important conclusion. One may be tempted to blame mail declines on reductions in general economic activity associated with the current recession. However, unsteadiness in overall mail demand, as well as declines in first-class mail, began before the current recession started. It is likely that the current downturn, as well as the September 11<sup>th</sup> terrorist attacks, exacerbated mail declines that would have or were already taking place due to underlying economic forces. Consequently, it is difficult to imagine a scenario under which mail demand will rapidly recover even if there were a robust economic recovery in the near future, which appears unlikely in any event. Postal reform must take this into account by allowing costs to adjust accordingly.

It bears repeating that these declines reflect fundamental market demand for the Postal Service's core activities. They are not driven by changes in policy toward the Postal Service, but by customers' underlying willingness to pay for the service of delivering physical mail. That willingness to pay is falling as households become increasingly comfortable with electronic alternatives to physical mail delivery. Internet communications now allow households to send and receive email, to pay bills online, to receive statements online, and to send and receive electronic documents quickly and reliably, all of which competes with physical communications.

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<sup>8</sup> Many commentators, including myself, have long predicted that advancing internet use and electronic communications would cause mail volume to decline and make significant postal reform imperative. In 2003 I wrote that:

. . . technological developments in communications make postal reform inevitable. The growth of substitutes for letter mail in the form of the telephone, facsimiles, and particularly electronic mail suggests that postal revenues cannot be maintained at current levels without substantial rate hikes. Additional rate increases will only invite further substitution into those alternatives. Barring a return to large annual deficits and the accompanying direct taxpayer subsidies, the USPS is unlikely to remain viable for long in its present form. Meaningful structural change is necessary.

*Saving the Mail* (p. ZZZ). For a much earlier but similar prediction, see James Bovard, "The Slow Death of the U.S. Postal Service," Cato Policy Analysis No. 102 April 3, 1988.

As broadband internet penetration and computer use rises, more households will find it efficient to substitute into electronic communications. There is no public policy under consideration – nor should there be – to reduce internet use. On the contrary, public policies designed to increase broadband internet penetration and computer use hasten physical mail’s decline.

Volume declines are likely to accelerate as social norms about charging customers to receive physical documents change. Banks and investment companies now regularly charge for physical delivery. The federal credit union now charges \$60 per year for mailed statements.<sup>9</sup> Charging for physical mail receipt, which further encourages internet use, is consistent with companies’ incentives to reduce costs. Moreover, physical document receipt is now often viewed as inconsistent with broader environmental and social goals. It is thus likely that the Postal Service has passed a tipping point in mail usage from which volume is unlikely to recover.

Unsurprisingly, declining mail volume is manifested in lower revenue. Figure 3, which displays operating revenue in terms of constant 2009 dollars, mirrors Figure 1. As noted above, operating revenue is down 15 percent since its peak. This cannot be attributed solely to the global financial crisis and current recession: since 1999 growth in operating revenue has been either small or negative with the exception of only two years in the mid-2000’s, suggesting weak demand prior to the recession.

The Postal Service’s fiscal situation is worse than this discussion suggests, however. Some aspects of the Postal Service’s business exhibit scale economies. Economies of scale exist when the unit cost of production falls as output (i.e. firm size) grows.<sup>10</sup> Given the large fixed costs associated with establishing a nationwide delivery network, it is likely that unit costs decline with size, at least over some ranges of output. The Postal Service and, prior to 1970, the Post Office, benefitted for decades from lower unit costs as a result of robust growth in mail.

Economies of scale may now be working to increase unit costs as volume falls. Figure 5 in the appendix displays real operating cost per mail piece, which approximates unit, or average,

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<sup>9</sup> Clayton B. Reid, “Undeliverable,” *Newsmax*, October 2011, p. 30.

<sup>10</sup> Importantly, economies of scale and network economies are separate concepts. Non-network industries can exhibit economies of scale.

cost. If economies of scale are present, this number will decline as mail volumes rise.<sup>11</sup> Figure 5 indicates that unit cost declined from the mid-1970s to the mid-1980s. However, unit-cost declines stopped for over two decades after 1984, increasing sharply in recent years. Real unit cost is now at about the level it was in 1978. Although not dispositive, Figure 5 is consistent with the Postal Service exhibiting diseconomies of scale in that unit costs are rising as volume declines.

One might ascribe an increase in unit cost to the 2006 Postal Reorganization and Enhancement Act's (discussed below) requirement that the Postal Service pay down its unfunded retiree health care costs through an annual \$5.5 billion payment to the U.S. Treasury. However, recent data indicate that unit cost increases have accelerated in recent years. Unit cost displayed an improvement (decline) of 0.30 percent in 2008, an increase of 3.87 percent in 2009, and increase of 7.23 percent in 2010. This is difficult to reconcile with the effects of an added cost of a fixed annual payment, but is consistent with falling volumes generating diseconomies of scale. It is risky to base any conclusion on so few observations (2011 data will be helpful), but this provides at least some evidence that diseconomies of scale will further challenge the Postal Service's fiscal viability.

There is another effect contributing to the Postal Service's fiscal challenges by virtue of its network structure. As the U.S. economy and its population expand, the number of delivery points that the Postal Service must serve, currently six days per week, also increases.<sup>12</sup> That is, the size of the Postal Service's network is growing even though overall mail volumes are falling. Given declining mail volume, the Postal Service must deliver less mail to an ever-larger network, raising the cost per piece delivered. This further strains the Postal Service's resources.

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<sup>11</sup> This measure will also decline as technological change lowers production costs. A more detailed analysis is necessary to separate the effects of those two complementary forces.

<sup>12</sup> This relates to the Postal Service's "universal service obligation," or USO. Importantly, what is currently viewed as the Postal Service's USO of six-day per week delivery to essentially every address at uniform rates does not appear in any U.S. postal law, and appears first in USPS literature in the 1996 Annual Report of the U.S. Postal Service. See the work of James I. Campbell Jr. on this issue. The number of delivery points served by the Postal Service increased by 14.57 percent between 1997 and 2009 (*Annual Report of the U.S. Postal Service*, various years).

Although its network structure makes adjustment more difficult, at their core the Postal Service's current challenges are a classic case of new, better and cheaper technology reducing customers' willingness to pay for the old. This is common in any economy that evolves. The automobile reduced the demand for horses. Cellular telephones reduced the demand for land line phones. Computers reduced the demand for typewriters. Calculators reduced the demand for slide rules, and so on. To capture the gains to consumers from new technology, public policy must be constructed to allow old industries to adjust to new, lower demand. Postal policy is no exception. Before discussing the postal reforms appropriate to adjust to new global communications marketplace, it is useful to review the most recent postal reform effort, the Postal Accountability and Enhancement Act of 2006.

### **III. The Postal Accountability and Enhancement Act of 2006**

Congress passed the Postal Accountability and Enhancement Act (Public Law 109-435, often referred to as the PAEA) late in 2006 after many years of deliberation. Its passage took some observers by surprise, and mandated by far the largest legislative changes to the U.S. Postal Service since its creation through the Postal Reorganization Act of 1970. It provided the Postal Service with more flexibility to adjust rates, which is a power it had long sought. It also shifted the regulation of monopolized services from a more traditional cost-of-service approach to a price cap regime. It strengthened the power of its regulator – the renamed Postal Regulatory Commission. It also resolved important issues with regard to funding of the Postal Service's pension liabilities.

Although it generated much excitement, some commentators suggest that the Act did not institute sufficient changes to allow the Postal Service to control its costs.<sup>13</sup> It did not help the USPS address its exceptionally high labor costs, which account for about 80 percent of its overall costs, nor did it reduce the ability of Congress to interfere with decisions about streamlining mail

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<sup>13</sup> See Michael Schuyler, *Congress Delivers Postal Service Legislation*, Institute for Research on the Economics of Taxation, Advisory No. 216, January 8, 2007.

processing and distribution facilities.<sup>14</sup> Moreover, the Act did not privatize or de-monopolize the Postal Service, or meaningfully move it toward such reforms.

One recurring concern involved the rate-setting process, which many commentators viewed as cumbersome and inappropriate in a competitive communications marketplace. The PAEA instituted a number of changes in the rate-setting process. It mandated the separation of postal products into “market dominant” (meaning those where the delivery monopoly applies) and “competitive” products, which face competition within their markets.<sup>15</sup> For products in the market-dominant category, the USPS may increase rates on its own authority, provided that those rates do not rise faster than the consumer price index. Rates may be increased faster than the CPI only in “extraordinary and exceptional” circumstances. Under the old law, the Postal Service was required to submit proposed rate changes to the Postal Rate Commission, often waiting many months for a decision. The new law alleviates the need for rate hearings, which in the past have been lengthy, cumbersome, and costly.

The USPS may price services designated as competitive as it wishes as long as each product covers its costs, and if all competitive products together make an appropriate contribution to USPS ‘institutional’ or overhead costs. This regulatory approach is similar to rate-setting under the old law. A central goal of the separation of product types is to help prevent the cross-subsidization of competitive products with revenue from monopolized products.<sup>16</sup>

The second main element of the PAEA was to ensure that unfunded liabilities the Postal Service had incurred since 1971 were addressed. In an April 2010 study, the General

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<sup>14</sup> Indeed, the only labor cost reform in the bill is a relative minor three-day waiting period for the filing of workers’ compensation claims.

<sup>15</sup> The Act lists first-class mail letters and sealed parcels; first-class mail cards; periodicals; standard mail; single-piece parcel post; media mail; bound printed matter; library mail; special services; and single-piece international mail, as market-dominant products [39 USC 3621(a)(1)-(10)]. The Act lists priority mail, expedited mail, bulk parcel post, bulk international mail, and mailgrams as competitive products [39 USC 3631 (a)(1)-(5)]. Some of the services the Act places in the market-dominant category are products that are actually in competitive markets, such as money orders, non-bulk parcels, and non-bulk international mail.

<sup>16</sup> See Geddes (2008).

Accountability Office identified approximately \$88 billion in unfunded liabilities incurred by the Postal Service, most of which were due to retiree health care costs.<sup>17</sup> The PAEA required the Postal Service to make a series of annual payments to the U.S. Treasury to ensure that those liabilities were addressed.

The pre-funding requirement of the PAEA is important. As the above analysis suggests, the Postal Service's fiscal outlook is bleak. The effect of growth in electronic communications on mail volumes was observable in 2006, and the fiscal implosion now in progress was easily predicted. It is less and less likely over time that the Postal Service will be able to reduce the liabilities identified by GAO out of revenue paid by mailers, and to therefore pay down the liabilities as soon as possible. Stated differently, it is less likely over time that large mailers and other postal system users would be willing to cover the liabilities (though their willingness to pay for postage) incurred by the system since 1970, and more likely that those liabilities would be transferred to taxpayers. The only other possibility is that pension and health care commitments to retirees would not be honored, which is unlikely.

Broadly speaking, the PAEA can be viewed as extending the 1970 Postal Reorganization Act in that both moved the Postal Service closer to the structure of a typical corporation. A key 1970 goal was to make the Post Office more managerially and financially independent of politics by creating an independent governmental agency that was required to break even over time, and where managerial decisions such as postmaster selection would be left up to management. The PAEA further moved the Postal Service toward a private corporate structure by requiring it to cover its liabilities out of revenue, by subjecting it to antitrust enforcement, and by dividing its products into competitive and monopolistic categories, where the prices of monopolized products are subject to price caps, as for many private utilities.

It is time for postal reform in the United States to take the next logical step in this long process, and to eliminate the postal monopoly and subject the Postal Service to typical private corporate law, i.e. corporatization. Before describing why and how those reforms should take

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<sup>17</sup> See U.S. General Accountability Office, U.S. Postal Service: Strategies and Options to Facilitate Progress Toward Financial Viability (April 2010)

place, I discuss another important factor militating for reform: the changing composition of the mail.

#### **IV. The Changing Nature of Mail**

There is another reason to undertake postal reform in the United States that is arguably more important than the Postal Service's fiscal decline. The composition of the mail has changed to such an extent that there is no longer a compelling public interest served by enforcing the Postal Service's dual monopolies, exempting it from corporate and property taxes, and retaining government ownership.

The Postal Service's 2010 *Household Diary Study* indicates that about 90 percent of the mail now originates with businesses.<sup>18</sup> It is composed mainly business material such as advertisements and catalogs. As with the Postal Service's fiscal problems, the sources of this change are mainly technological. Electronic communications allow Americans to rely less on postal services to correspond and communicate with others, resulting in a decrease in personal mail. The remaining mail has thus become more commercial in nature.

According to various years of the *Household Diary Study* personal correspondence, which includes personal letters, greeting cards, and invitations, decreased by over 15.5 percent between 2005 and 2010. The two categories of personal correspondence showing the largest declines over this time were personal letters (almost 31 percent decline) and invitations (over 36 percent).<sup>19</sup> Only about 3 percent (5.2 billion out of 170.6 billion in 2010) of all mail is now from households to other households. The remaining mail is correspondence between households and non-households, mostly businesses. Advertising material accounted for 59 percent of all mail

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<sup>18</sup> John Mazzone and John Pickett, *The Household Diary Study: Mail Use and Attributes in FY 2009*, (Washington, D.C.: the U.S. Postal Service, April 2010). Available at: <<http://about.usps.com/studying-americans-mail-use/household-diary/2009/fullreport-pdf/usps-hds-fy09.pdf>>, accessed October 30, 2011. 2009 data are the most recent.

<sup>19</sup>See Mazzone and Pickett (2011), Table 3.10. The Study defines "correspondence" as non-sales-related communication i.e. letters and greeting cards. It can however include both personal and business-related communications, so correspondence is likely to overstate the amount of personal communications that takes place via the Postal Service, and to greatly overstate personal letters.

received by households in 2010. Overall, only about 10.5 percent of all mail originated with households in 2010, and a large portion of that is business-related. This implies that more than 90 percent of all mail originates with non-households, and is mostly commercial in nature.

These developments call traditional public interest justifications for government intervention in postal services into question. In the past, government intervention was justified through claims that physical mail delivery “bound the nation together.” This was likely true in the 19<sup>th</sup> century when revenue from letter mail postage in eastern cities was used to cross-subsidize the delivery of newspapers to frontier states, under the view that receiving the news would make rural citizens feel more a part of the broader Union.<sup>20</sup>

Those days are now gone. The Postal Service today is, by and large, a broadcast medium for the delivery of commercial material. Moreover, the Post Office's original public mission of "binding the nation together" is obsolete when people not only in the nation, but around the world, can communicate instantly via the internet, and receive only catalogs and advertisements by mail. Separate from rapidly declining mail volume, it is difficult to argue that the Postal Service continues to provide a critical public service when customers refer to its core business as “junk mail.” Although advertising performs an important social function by providing information to consumers, the cost of that advertising is normally absorbed by the company wishing to advertise, rather than being guaranteed through a government-owned monopoly structure. Public interest justifications for retaining that structure in order to ensure the delivery of material that is overwhelming commercial in nature are weak. This has been recognized by postal experts. As former Postal Regulatory Commission chairman and George Mason University professor A. Lee Fritschler stated in 2009:

The base problem confronting the contemporary Postal Service is that the environment in which it operates has changed drastically. It is less and less a conduit for exchanging first class letters and more and more a broadcast medium, primarily for the distribution of

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<sup>20</sup> See Richard R. John, *Spreading the News: The American Postal System from Franklin to Morse* (Cambridge, Harvard University Press) 1995.

advertisements, periodicals, and parcels . . . Today, the reasons for establishing the Postal Service as a government monopoly are fast disappearing.<sup>21</sup>

Extensive institutional reform is today appropriate not only because of volume and revenue declines, but also because of major changes in mail composition. I describe the form that those changes should take in the following section.

## **V. Postal Reform for the Internet Age**

The lack for a compelling public interest rationale for government intervention in mail services, combined with massive fiscal challenges, suggest that significant structural and institutional reform is both necessary and timely. Reform should continue in the spirit of the 1970 Postal Reorganization Act and the 2006 Postal Accountability and Enhancement Act by allowing the Postal Service to become a fully independent corporation subject to private corporate law, market competition, and disciplined by focused, active shareholders.

De-monopolization, corporatization, and privatization will generate a host of social benefits. To the extent that there is sufficient market demand to support the delivery of commercial material to households (i.e. to provide the “last mile” of delivery), then de-monopolization ensures that delivery service of that material will be provided competitively, and at least cost. Inefficiencies created by decades of government-enforced monopoly that insulated the Postal Service from competition will be reduced. Increased efficiencies are likely to reduce mail rates overall, as suggested by the experience of deregulation in other network industries such as trucking, railroads, airlines, long-distance telecommunications, and others.<sup>22</sup> De-monopolization of mail is also taking place in many other countries, such as in all European Union countries.<sup>23</sup>

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<sup>21</sup> A. Lee Fritschler, “Liberating the Postal Service,” *Huffington Post*, May, 20, 2009, available at: [http://www.huffingtonpost.com/a-lee-fritschler/liberating-the-postal-ser\\_b\\_206037.html?view=print](http://www.huffingtonpost.com/a-lee-fritschler/liberating-the-postal-ser_b_206037.html?view=print) (accessed October 30, 2011).

<sup>22</sup> See Geddes (2003, pp. 86-95) for a discussion of the empirical effects of deregulation of other U.S. network industries on rates, profits, wages and employment.

<sup>23</sup> “The European Union has ordered the end of virtually all national postal monopolies by the end of the year 2010.” A. Lee Fritschler, “Liberating the Postal Service,” *Huffington Post*, May, 20, 2009, available at:

Additionally, rather than a one-size-fits-all mandate, service levels can be adjusted to the volume of mail on particular routes. Some routes that are not profitable under six-day-per-week delivery may be profitable under three or four day delivery, and so on. Similarly, under de-monopolization, the Postal Service can adjust its pricing in a sensible way. If an advertiser wanted to blanket a particular zip code for a short period of time for six days per week to announce a new sale, for example, the Postal Service could private that delivery appropriately. Such adjustments were observed in other network industries after deregulation, such as airlines' introduction of a variety of aircraft sizes tailored to meet the needs of particular routes.

In addition to introducing competition, the Postal Service should be corporatized prior to privatization. Corporatization means that the Postal Service would be subject to the standard body of law to which all U.S. privately owned, publicly traded corporations are subject. The Postal Service would be subject to the corporate law of a particular state.<sup>24</sup>

Corporatization would have a number of benefits, such as designating the board of directors and senior managers to be explicit fiduciaries of the firm's owners: U.S. taxpayers. The board and managers must then operate the firm in taxpayer's interest. With that designation comes a highly evolved, broadly understood set of fiduciary principles, the most general of which are a duty of care and a duty of loyalty to firm owners. There are also more specific directives such as those against conflicts of interest and "looting" of the firm.<sup>25</sup>

The social benefits of this one legal change, which is standard in private corporations, are legion. Fiduciary principles give direction and focus to the firm's board and its senior managers,

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[http://www.huffingtonpost.com/a-lee-fritschler/liberating-the-postal-ser\\_b\\_206037.html?view=print](http://www.huffingtonpost.com/a-lee-fritschler/liberating-the-postal-ser_b_206037.html?view=print) (accessed October 30, 2011).

<sup>24</sup> Work by Roberta Romano suggests that competition among states for incorporations produces the most highly evolved corporate law. See e.g. Roberta Romano, *The Genius of American Corporate Law* (Washington, DC: AEI Press) 2003. The Postal Service should be subject to the strictures of some particular state's corporate law, such as Delaware.

<sup>25</sup> See e.g. Frank H. Easterbrook and Daniel R. Fischel, Ch. 4, "The Fiduciary Principle, the Business Judgment Rule, and the Derivative Suit," in *Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991) for a discussion of the economic effects of fiduciary principles.

and would reduce the confusion surrounding many postal decisions. It is difficult to overstate the value of such clear direction. Although taxpayers are the true owners of the Postal Service, they are often forgotten in many postal policy debates. Assigning fiduciary duties would make it clear that taxpayers are the true, legal residual claimants of the firm. Residual claims are well-defined property rights to the firm's net cash flow, and clear assignment of them is critical for efficient firm operation.<sup>26</sup>

Corporatization would also reduce the scope for congressional meddling in what are fundamentally business decisions, thus addressing one of the Postal Service's most challenging problems. By corporatizing the firm, the responsibility to protect taxpayer's interest is delegated explicitly to the board and managers through their fiduciary duty to taxpayer-owners. From fiduciary principles stems another important, highly evolved rule: the business judgment rule. Described simply, the business judgment rule states that the law and the courts should not second-guess the business decisions of boards and managers, provided that they were acting honestly. In the Postal Service's case, this convention implies that, once Congress delegates the duty to operate the firm in taxpayer's interest to its officers and directors, it should then defer to the business decisions of those officers and directors.

Postal Service officers and directors would then also be free of congressional interference to prepare the firm for privatization, which is simply giving its taxpayer-owners the option of selling their ownership shares on market where ownership interests in publicly traded firms are bought and sold – a stock market. That preparation is critical, because there is enormous taxpayer value locked inside the Postal Service currently due to restraints on managerial decisions. To provide just one example, the Postal Service's real estate portfolio is likely to have substantial market value. As reported in Table 2 in the appendix, as of 2010 the real estate owned by the Postal Service included 8,621 properties, almost 200 million square feet of interior space, and almost a billion square feet of land. Through the Postal Service, taxpayers own prized real estate in numerous downtown locations, including its headquarters in L'Enfant Plaza in Washington, its Boston Processing Center, and its massive James A. Farley Building in Manhattan. This real

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<sup>26</sup> For a detailed discussion of the importance of defining residual claims in postal services, see R. Richard Geddes, "Agency Costs and Governance in the United States Postal Service," Ch. 5 in J. Gregory Sidak, ed., *Governing the Postal Service* (Washington, DC: AEI Press, 1994).

estate has enormous market value, likely in excess of the \$27 billion reported on the Postal Service's 2010 balance sheet as purchase price.<sup>27</sup>

A corporatized Postal Service operating in taxpayers' interests would of course need substantial real estate to operate its business. However, it could also divest itself of substantial buildings and land in prime downtown locations, and restructure its network to realize substantial net gains for taxpayer-owners. For example, it would certainly need corporate headquarters, but it does not need a large building in downtown Washington DC to meet those needs. Restructuring its real estate portfolio would be a straightforward way to unlock the massive latent taxpayer value now imbedded in the Postal Service, and could be undertaken under a corporatized structure. Such value could then be used to retire unfunded liabilities and U.S. Treasury debt incurred by the Postal Service.

There is much additional hard managerial work that must take place to properly prepare the Postal Service for privatization. This includes streamlining and rationalizing the delivery network, as well as additional investment in new capital, such as postal vehicles and new sorting technologies. Many underutilized post offices would need to be closed, with those services replaced by contracts with drug stores, supermarkets, and other outlets.

This is consistent with what has been done in other countries. The German mail authority Deutsche Bundespost was privatized in 1995, and now maintains only a few post offices of its own, including one in the German Parliament Building. In Britain, the *Postal Services Act of 2011* allows the government to privatize up to 90 percent of Royal Mail, with 10 percent being held by Royal Mail employees. Royal Mail has already closed about 95 percent of its post offices. Holland recently closed its remaining post office.

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<sup>27</sup> To provide a very crude estimate of the market value of postal real estate in 2010, I utilized the assessed values of a sample of ten postal properties reported in Table 1 of a July 12, 2011 memo written by the USPS Office of Inspector General, entitled, "Management Advisory -- Leveraging Assets to Address Financial Obligations, Report Number FF-MM-11-118," available at: [http://www.uspsoig.gov/foia\\_files/FF-MA-11-118.pdf](http://www.uspsoig.gov/foia_files/FF-MA-11-118.pdf), accessed October 30, 2011). Using a simple average, I calculated the difference between the recorded (purchase) price of those assets and the 2010 assessed value as an increase of 176.62 percent. I then applied that increase to the Postal Service's recorded \$27 billion to obtain \$47.5 billion.

The Postal Service has already been reducing both the number of total employees and the number of career employees since their peak in 1999. The number of total employees has fallen by 26 percent since then, while the number of career employees has fallen by 27 percent, without layoffs. It is likely that a corporatized Postal Service would continue this policy, since the Postal Service is labor intensive relative to other delivery services.<sup>28</sup>

Once these challenging managerial decisions are made, taxpayers' should be given the option of "cashing out" of their interest in the Postal Service by selling shares on a market. There is no public policy rationale for forcing taxpayers to keep their value locked inside the Postal Service. Disallowing taxpayers from selling their interests results in what I have termed "captive equity."<sup>29</sup> This results in distorted allocative decisions due to an artificially low cost of capital relative to a private firm that must raise capital from those who invest it voluntarily.<sup>30</sup>

Privatization is the final stage in converting the Postal Service into a de-monopolized firm subject to corporate law and the disciplining effect of active shareholders. A postal initial public offering of shares would reveal the value of an efficiently structured Postal Service as a going concern, and that value would likely be substantial. Although postal revenues are declining, they are still large by most standards: the Postal Service received over \$67 billion in revenue in its 2010 fiscal year. This is well over twice the annual operating revenue for McDonalds in that year, and about 7 percent more than Microsoft. Businesses are still willing to spend large sums on direct mail advertising through the Postal Service. Additionally, a corporatized Postal Service facing market competition would have the incentive to search aggressively for new revenue sources, such as advertizing on its delivery trucks and offering new

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<sup>28</sup> Labor costs represent about 80 percent of the Postal Service's expenses, compared with 53 percent at United Parcel Service and 32 percent at FedEx. See Steven Greenhouse, "Postal Service Is Nearing Default as Losses Mount," *New York Times*, September 4, 2011, available at: <http://www.nytimes.com/2011/09/05/business/in-internet-age-postal-service-struggles-to-stay-solvent-and-relevant.html?ref=postalservice> (accessed October 30, 2011).

<sup>29</sup> For a discussion of the concept of "captive equity" in a different context, see R. Richard Geddes, *The Road to Renewal: Private Investment in U.S. Transportation Infrastructure* (Washington, DC: AEI Press, 2011), pp. 81-84.

<sup>30</sup> *Ibid.*

delivery products. Assuming an efficient, optimized Service could earn 7 percent in terms of earnings before interest and taxes (EBIT), and purchasers of shares were willing to pay a typical multiple of 8 times earnings in an initial public offering for an industrial company, then taxpayers could realize almost \$40 billion in a postal IPO.

## **VI. Subsidizing Mail Delivery via Route Bidding**

Suppose, however, that Congress did not accept the analysis above regarding the public interest rationale for government intervention in postal services in the internet age, and determined that subsidizing physical mail delivery was still desirable.<sup>31</sup> Congress must then make two decisions in light of electronic document delivery and an increasingly commercialized mail stream. First, what level (such as days per week) of government-guaranteed mail delivery is appropriate in such a world, keeping in mind that differing levels of service may be appropriate for different routes.

Second, if Congress decides service on some routes is worthy of a direct taxpayer subsidy, what is the cheapest and most transparent way to pay that subsidy? Taxpayers have a right to know exactly what they are paying for guaranteed mail service, as well as assurances that they are paying the minimum necessary. That is, both transparent and least-cost subsidies are socially desirable.

Even if Congress makes such a determination, there is still no compelling rationale for retaining the Postal Service's traditional government-owned monopoly structure to provide such subsidies. Indeed, retaining that structure is probably the most wasteful way of ensuring delivery on certain routes. Congress can still introduce the single most potent force to guarantee that service: competition. It can do so by soliciting bids from competitive private delivery companies based on which one will provide that service for the lowest possible subsidy. This is known as "route bidding" or "route contracting."

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<sup>31</sup> Stated differently, Congress may decide to "preserve universal service" even though physical mail delivery is now mostly commercial, and the Postal Service currently has no legally defined universal service obligation. This boils down to a concern about delivery to rural and poor areas.

Such a contracting approach is an extension of current postal policy. The USPS already pays out over \$4 billion per year to highway contractors where contracts for rural delivery are competitively awarded. Indeed, contractors have transported mail between postal facilities since 1792, and the Postal Service is increasing the number of service contracts. Major contractors with the Postal Service include FedEx, American Airlines, Mack Truck, Verizon, and Siemens. Competitive contracting already in use includes transportation contracts, where private suppliers transport mail between postal facilities, combination contracts, where suppliers make a small number of mail deliveries in the course of transporting mail among USPS facilities, and contract delivery service where suppliers collect and deliver mail in rural areas.

A transition period where the Postal Service, as a de-monopolized firm, were given the right of first refusal to serve all routes, would be important if this approach were taken. That is because it is unknown before the fact which routes a private firm would serve and how frequently. The government need only subsidize those routes where the Postal Service withdrew to the point where service were below the Congressionally determined level, and should then place that added service out to bid.

The federal government has a body in place that could conduct such bidding: the Postal Regulatory Commission. The Commission's task would be to ensure that all routes receive the level of service Congress designated for them, and that the required subsidies were both transparent and least cost.

This approach would still allow the Postal Service to evolve into a typical private corporation, and to bid itself on those routes it refused to serve without subsidies. If there are appreciable economies of scale in the Postal Service's delivery network, and many commentators believe, then the Postal Service would frequently emerge as the winning bidder anyway due to its cost advantage.

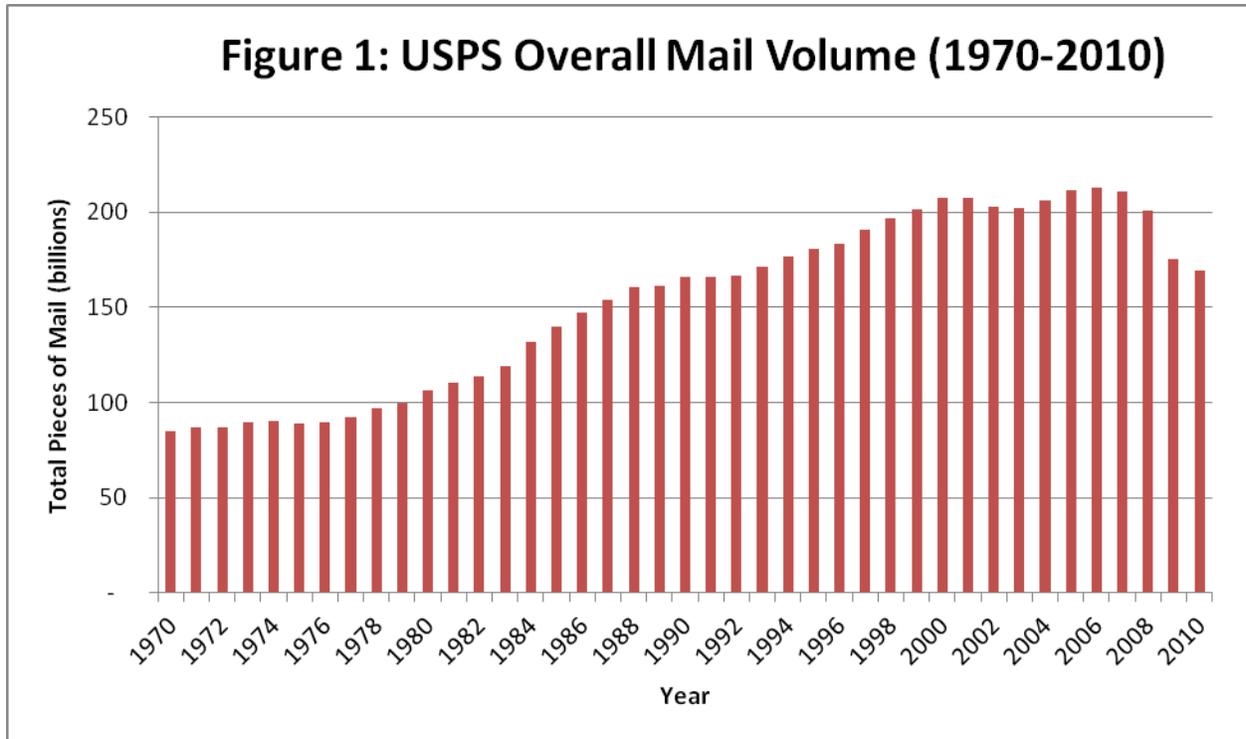
## **VII. Summary and Conclusions**

The public interest rationales for continuing the government-owned monopoly structure of the Postal Service, compelling in the 19<sup>th</sup> century, are obsolete in light of the drastically changed composition of the mail. The Postal Service is now essentially a broadcast medium for

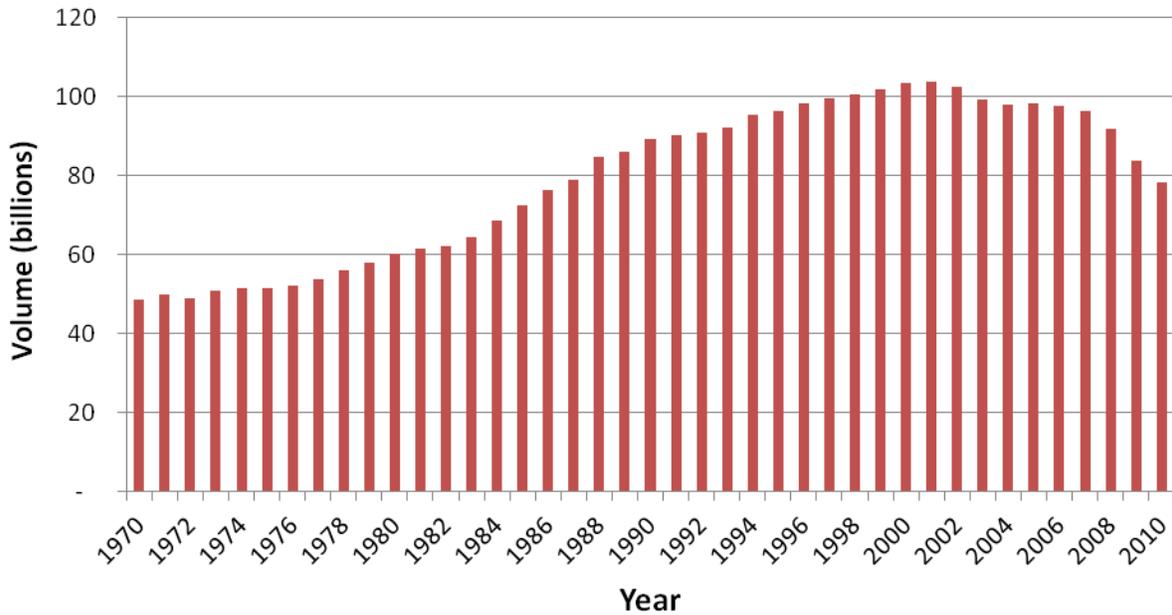
the delivery of commercial material. About 90 percent of all mail today originates outside of the household.

Moreover, the demand for physical mail delivery is falling rapidly, and the Postal Service's most profitable mail class – first-class – has fallen over 25 percent since its 2001 peak. There is no public interest rationale for large taxpayer subsidies to the Postal Service, particularly at a time of unprecedented federal deficits. Even if Congress determines that government-guaranteed delivery is nevertheless critical, it can guarantee that delivery through a system of competitive bidding for delivery to certain routes. In either event, the Postal Service can be put on a course towards de-monopolization, corporatization, and privatization.

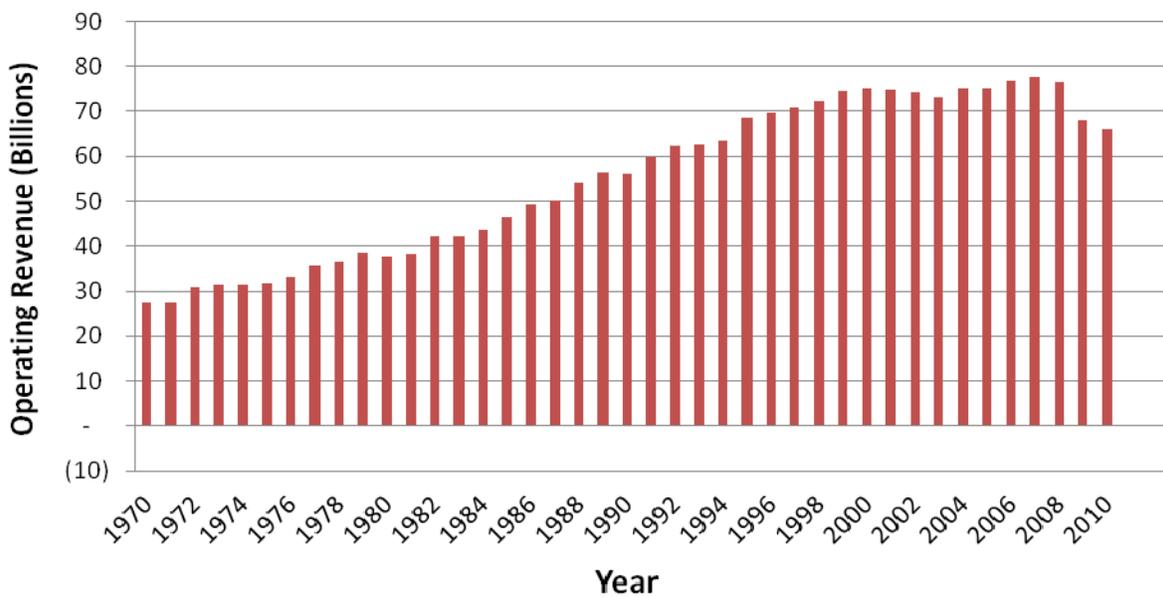
**Appendix A: Postal Mail Volumes, Revenue, and Profitability**



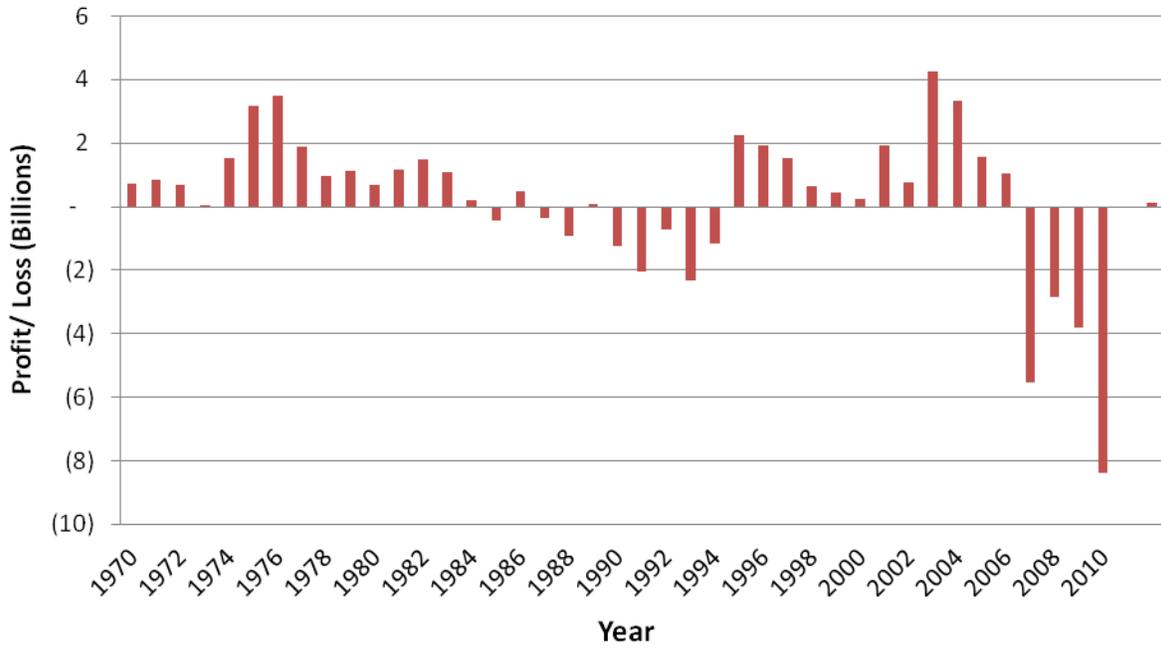
**Figure 2: USPS First-Class Mail Volume (1970-2010)**



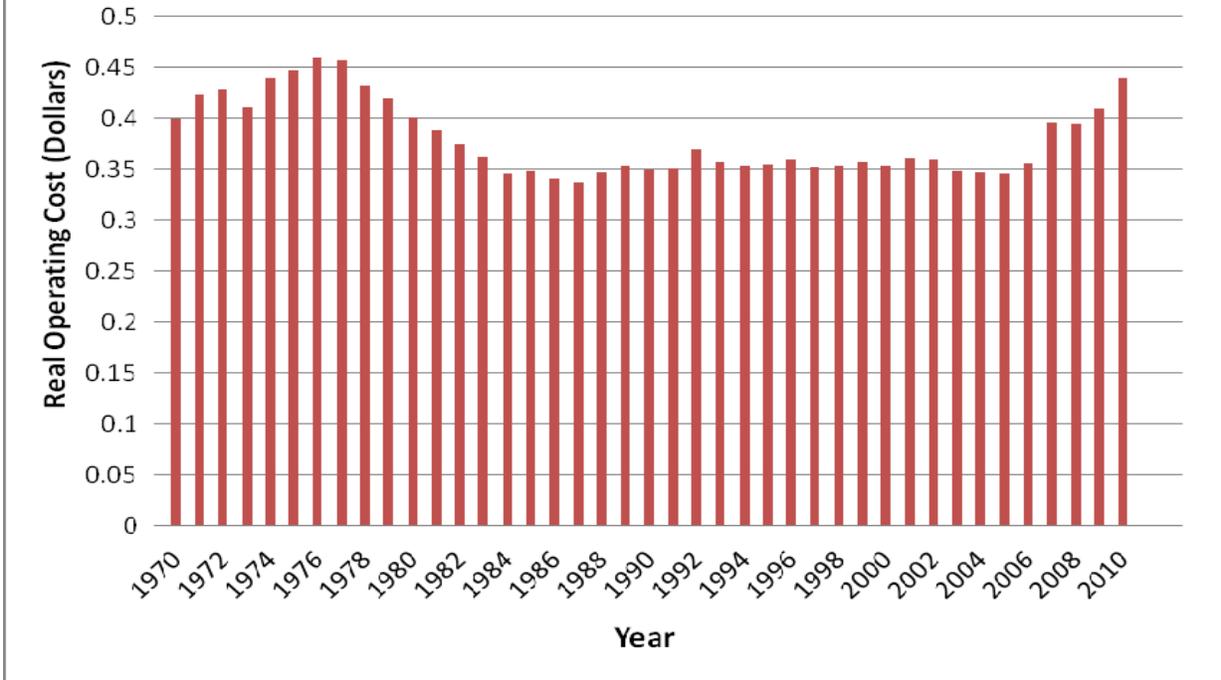
**Figure 3: Postal Service Operating Revenue (Billions of Real 2009 Dollars)**



**Figure 4: Postal Service Profit and Loss  
(Billions of Real 2009 Dollars)**



**Figure 5: Real Operating Cost per Piece of Mail**



**Appendix B: Postal Service Payments to Taxpayers Required under the PAEA**

Table 1. U.S. Postal Service Payments to the U.S. Treasury under the Postal Accountability and Enhancement Act of 2006.

Amount	Due Date	Status
\$5.4 billion	9/30/2007	Paid
\$5.6 billion	9/30/2008	Paid
\$5.4 billion	9/30/2009	Lowered to \$1 billion by P.L. 111-68 (USPS Annual Report, 2009, p. 35)
\$5.5 billion	9/30/2010	Paid
\$5.5 billion	9/30/2011	Delayed until November 18, 2011
\$5.6 billion	9/30/2012	Due in future
\$5.6 billion	9/30/2013	Due in future

\$5.7 billion	9/30/2014	Due in future
\$5.7 billion	9/30/2015	Due in future
\$5.8 billion	9/30/2016	Due in future

Note: I am grateful to Michael Schuyler for providing these data. The source for the original payment schedule was the Postal Accountability and Enhancement Act (P.L. 109-435).

In addition to the above, the PAEA required transfers into the Retiree Health Benefits Funds of \$2.958 billion on April 6, 2007 and \$17.1 billion on June 29, 2007 (which was the surplus in the CSRS fund as of September 30, 2006). Source is *USPS Annual Report, 2007*, pp. 25-26.

**Table 2. Postal Service Real Estate as of Year's End 2010**

<b>Property Type</b>	<b>Amount</b>
Owned properties	8,621
Owned interior square footage	198,081,325 square feet
Owned land in square feet	953,304,006 square feet
Leased properties	24,671
Leased interior square feet	88,247,231 square feet

Source: U.S. Postal Service, Foundation for the Future: 2010 Comprehensive Statement on Postal Operations (2010 Performance Report and 2011 Performance Plan), Available at: [http://about.usps.com/strategic-planning/cs10/CSPO\\_\\_12\\_2010.pdf](http://about.usps.com/strategic-planning/cs10/CSPO__12_2010.pdf) (accessed October 29, 2011).