



Statement before the
U.S. Senate Committee on Homeland Security and Government Affairs
On “Solutions to the Crisis Facing the U.S. Postal Service”

Solutions to the Crisis Facing the U.S. Postal Service

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Carper, Ranking Member Coburn, and distinguished Members of the Committee:

Thank you for the opportunity to submit testimony to the Senate Homeland Security and Governmental Affairs Committee hearing entitled, "Solutions to the Crisis Facing the U.S. Postal Service."

I am R. Richard Geddes, Associate Professor in the Department of Policy Analysis and Management at Cornell University, Visiting Scholar at the American Enterprise Institute, and Director of the Cornell Program in Infrastructure Policy.

I am pleased that the Committee is examining opportunities for innovative, long-term solutions to the problems facing the U.S. Postal Service.

The U. S. Postal Service is facing a major financial crisis. That crisis is driven by declining demand for the Postal Service's core activity – the delivery of first-class mail – combined with the cost of maintaining the extensive delivery network required to provide universal delivery service. First-class mail is important because it is the Postal Service's most profitable activity, and because ensuring the delivery of letters is the justification for the Postal Service's current organizational structure as a state-owned enterprise with a legally enforced monopoly over its core service.

As Figure 1 below illustrates, the decline in first-class mail has been significant. First-class mail volume reached a peak of 103,656 million pieces in 2001, and fell to 68,696 million pieces in 2012, representing a drop of over one-third. Declines of this magnitude in letter mail have not been seen since the Great Depression.

Although it is undoubtedly a contributing factor, first-class mail volume's dramatic decrease is not explained solely by recent weak economic growth. The decline began well before the 2008 global financial crisis. Moreover, that decline has continued even though the economy has improved. It is instead likely that diminishing mail demand is driven by the falling cost and increasing usage of electronic substitutes for physical mail delivery.

Alternative methods of communicating messages include telephone calls, electronic mail messages, text messages, and facsimiles, among others. Such methods have an advantage over physical mail delivery because they are both inexpensive and instantaneous. Increased use of electronic banking and electronic payment of bills, such as utility bills, have had a particularly large impact on mail volumes.

It is tempting to compare the Postal Service's current situation to other industries that have been overtaken by technological innovation. Examples include the horse and buggy in the dawning automobile era, typewriters after the development of word processors, or slide rules with the advent of low-cost, hand-held calculators. Such comparisons suggest that the Postal Service's fiscal crisis is inevitable. To the extent that younger people are more comfortable communicating electronically, demography indeed may be destiny for the Postal Service.

Fortunately, postal liberalization in other countries demonstrates clearly that, with proper policy reform, the postal and delivery sector can emerge from this technological challenge as a sustainable, vigorous, and profitable component of a developed economy. For that desirable outcome to be realized in the United States, however, we must remove existing legal impediments to the Postal Service evolving into a more innovative and entrepreneurial company.

Below I recommend two key reforms for the Postal Service: de-monopolization and corporatization. Liberalizing the U.S. Postal Service from its current commercial constraints and improving its governance represents a direct extension of the Postal Reorganization Act of 1970. The 1970 Act created the modern Postal Service out of the old Post Office, required it to break even over time, directed it to operate in a more businesslike manner, and instructed it to adopt modern management methods. The Act created a Board of Governors as a key governance device. In contrast to these reforms, relying on mainly cost cutting or ongoing taxpayer subsidies to survive such a major technological challenge will lead inevitably to waning and stunted U.S. postal sector.

The Postal Service's Fiscal Crisis

Declining revenue from mail combined with the Postal Service's cost structure has created a widening fiscal crisis. The Postal Service lost \$15.9 billion in its 2012 fiscal year ending September 30th. The Postmaster General recently stated that the USPS now loses approximately \$25 million every day, or \$17,361 per minute. Cumulatively, the Postal Service has lost about \$41 billion dollars over the past six years.

During 2012, it defaulted on \$11.1 billion of retiree health care prefunding obligations owed to the U.S. Treasury as required by the 2006 Postal Accountability and Enhancement Act.¹ It reached its \$15 billion borrowing limit with the U.S. Treasury by the end of 2012. Recent data from the Postal Service's first quarter of 2013 suggests that the crisis is unlikely to abate. First-class mail declined by about 4.5 percent for the quarter, while revenue from first-class mail declined by 3.1 percent. The Postal Service lost about \$1.3 billion for the quarter.

These developments have impacted the USPS' cash position. The Postal Service projects that, by the end of FY 2013, its cash balance will be less than its average weekly expenses of \$1.3 billion. Such a low cash level is risky, since it could prove insufficient to support operations in the event of a shock to demand or further weakness in the U.S. economy.

¹ Much recent debate has focused on the requirement in the 2006 Act that the Postal Service pre-fund its retiree's health care benefits. Actuarial experts within the Office of Personnel Management determined that such payments are a legitimate cost incurred by Postal Service operations, which should be paid through rates (instead of by taxpayers) as per the 1970 Act break-even requirement. I have no reason to question that judgment.

Solutions to the Crisis

Barring a return to the massive – and likely increasing – pre-1970 direct annual subsidies from taxpayers to the Postal Service, there are two broad approaches to addressing its mounting fiscal crisis. The first is to rely mainly on a “shrink to survive” strategy to assist the Postal Service in reducing its costs as the demand for its core service falls. This involves reducing the number of post offices, downsizing the postal workforce, closing large sorting centers, and reducing the level of service (such as delivery days per week and post office hours), among other reductions.

To some extent, this is the approach taken to date. The Postal Service has announced initiatives to close up to 4,380 retail postal facilities in suburban, urban, and rural areas. The Postmaster General recently reported the impending elimination of Saturday first-class mail delivery. The Postal Service has reduced hours of service at about half the nation's 26,000 post offices and reduced its workforce by 35 percent. Given that approximately 80 percent of the Postal Service's costs are labor-related, it is likely that further large reductions in employment and work hours would be necessary under this strategy.

This approach essentially accepts volume and revenue declines as immutable, and attempts to accelerate and formalize the cost reduction process. This may include such mechanisms as a military-base-closing-commission (BRAC) type board, which would be granted authority to formulate a list of postal facilities that should be closed, as well as granting the Postal Service more authority to reduce service levels.

There are several reasons why an overall “shrink to survive” strategy is unlikely to result in a sustainable Postal Service. There are two potential negative long-term effects of such a strategy, one on the demand side and one on the cost (or supply) side. Reductions in service levels (including delivery days per week and delivery speed) are important aspects of service quality that may affect demand. When the quality of service deteriorates, demand for that service may fall as well. Thus in addition to reducing costs, such reductions may have the unintended consequence of further reducing revenue. Moreover, there is a natural limit to how far costs can be cut without sacrificing the ability to provide a basic level of mail service.

On the supply side, an industry such as postal services exhibits economies of scale in some aspects of its operations. Economies of scale imply that unit costs fall as the firm's size increases. Conversely, rising costs per unit are associated with scale economies as demand declines. This second deleterious effect is critical for the reform debate, since economies of scale are often offered as the public policy justification for retaining a delivery monopoly.

To provide some background, economies of scale is the phenomenon that, in some industries, the unit cost of producing a good or service declines as the firm gets larger. That is, bigger firms are more efficient (i.e. lower cost) in production due to the process by which a good or service is produced. Economists often think of network industries such as water and electricity production as exhibiting economies of scale, although non-network industries, such as steel, are also offered as examples.

Economies of scale operate in both directions, however: costs per unit rise as the firm gets smaller. Thus falling mail demand as driven by substitution into electronic alternatives is not only causing revenue to decline, it is also causing unit costs to increase. This is illustrated by Figure 2 below, which indicates that inflation-adjusted operating costs per piece of mail have indeed been rising of late. Unit mail costs have returned to approximately where they were in the mid-1970s. This is consistent with economies of scale now working against the Postal Service as mail volume falls. Falling demand means that the Service is effectively caught in a fiscal vice, with declining revenue on one side and rising unit costs on the other. This is a second key reason why shrinking to survive alone is unlikely to result in a sustainable Postal Service.

Similarly, serious, sustainable reform should not focus mainly on restructuring the Postal Service's payments for retiree health care costs, as some commentators have advocated. The restructuring of such payments should only be undertaken within the context of broader structural reforms. Without major changes in the Postal Service's business model, further declines in mail demand and in revenues are likely.

A New Postal Service Business Model for the Electronic Age

The Postal Service's fundamental business model must be modernized to allow it to use its existing assets to discover new ways to better meet demand and to create new demand for physical document delivery. There are three key outcomes that any reform must create to result in a sustainable U.S. Postal Service: (i) strong, focused incentives to seek out new revenue streams; (ii) specialized expertise; and (iii) access to capital markets to fund innovation. Notably, the Postal Service has recognized this need, and has itself called for a major change to its business model. In its Quarter I, 2013 Report on Form 10-Q (p. 9) the Postal Service stated that, "Without structural change to the Postal Service's business model, it will continue to be negatively impacted by these [demand] factors and, absent legislative change, it anticipates continuing quarterly losses for the remainder of 2013."

There are two key reforms that will allow the USPS to be sustainable in the new communications marketplace. The first is de-monopolization and commercialization, and the second is corporatization.

De-Monopolization and Commercialization

The concepts of de-monopolization and commercialization are critical for postal reform, and are inextricably linked. De-monopolization refers to repeal of the Postal Service dual monopolies. These concepts are sometimes referred to collectively as postal "liberalization." It currently receives a legally enforced monopoly over the delivery of any item defined as a letter, and another over the use of a household's mailbox. Commercialization refers to the process of allowing the Postal Service to become entrepreneurial and innovative in entering new markets and in creating new product offerings. This means using its existing delivery network to generate more economic value.

These two reforms are inextricably linked because the Postal Service will never receive commercial freedom without de-monopolization, nor should it. Legal enforcement of monopoly power is always accompanied by regulatory oversight of the monopoly, which is appropriate. This stems in part from a fear that, if the monopolist were to venture into new business activities, it might utilize profits from its monopolized activity to unfairly subsidize activities where it faces competition. Indeed, such a concern was an important motive in separating postal products into “market dominant” and “competitive” categories in the 2006 Postal Accountability and Enhancement Act.

Another by-product of legally enforced monopoly is regulation of rates. This stems from a concern that a firm receiving a monopoly may charge excessively high rates. Rates charged by the Postal Service are currently overseen by the Postal Regulatory Commission. The Postal Service also receives pricing flexibility through de-monopolization and commercialization.

Postal laws should be reformed to allow the Postal Service to use its most valuable asset – the network that gives it the ability to deliver mail to every address on a regular basis – in new and innovative ways to meet existing demand and to offer new delivery products. Many stakeholders would share in the benefits from the creation of such added economic value, including customers, employees, and of course mailers.

Although the Postal Service does attempt, within the confines of the law, to raise new revenue, it has noted that existing legal constraints on its ability to generate added revenue are binding. In its Quarter I, 2013 Report on Form 10-Q (p. 26), it stated that:

Moreover, unlike a private-sector business, the Postal Service is restricted by law from taking certain steps, such as entering new lines of business, that might generate additional revenue to make up for some of the decline in First-Class Mail revenue. We are also constrained by a price cap imposed on First-Class Mail and Standard Mail prices, which generates almost 70% of our total revenues. As a result, under current regulations, the Postal Service cannot grow revenue sufficiently to compensate for the decline in First-Class Mail revenue.

To facilitate revenue growth, any sustainable reform must contain de-monopolization and its complement, commercialization. Notably, such reforms are consistent with market trends. The value of the Postal Service’s delivery monopoly has eroded with falling mail demand. Policy concerns regarding possible misuse of that monopoly power are thus becoming less salient. Moreover, a bright spot in postal operations is in package and shipping services, which increased 4 percent in the first quarter of 2013. This is not surprising, since internet shopping has increased the demand for home delivery of parcels.

Package and shipping is however one of the Postal Service’s most competitive markets. The ability of the Postal Service to innovate and succeed in those markets is becoming more important with such market changes. Liberalization is critical to allow the USPS to become as

innovative as possible in those markets and is a reflection of market trends. The importance to the Postal Service of obtaining true commercial freedom is thus rising over time because of demand changes.

It is also noteworthy that granting the Postal Service more commercial freedom is consistent with the 1970 Act that created the Postal Service and instructed it to operate in a businesslike fashion. It is difficult to fulfill such a mandate when fundamental business decisions such as pricing, service offerings, and service levels, are constrained by oversight of its monopolies.

Economists have often under-estimated the degree of innovation that is likely to occur when an industry is liberalized. For example, when airlines were deregulated, many experts were surprised by innovations such as the hub-and-spoke system, and by the development of aircraft that vary greatly in size and type, and are tailored to the route. This suggests that, after liberalization, the postal sector is also likely to adopt impressive innovations to better meet demand with its existing assets, and that such innovations are difficult to predict *ex ante*.

Corporatization versus Privatization

In addition to revenue-side liberalization, changes in the Postal Service's organizational structure are necessary to improve governance, to attract the managerial talent, experience, and the focused incentives that are critical for its fiscal sustainability. The first step is *corporatization*, which is distinct from *privatization*. Corporatization refers to subjecting the Postal Service to the usual set of corporate laws and norms associated with a modern, large, commercial entity. It includes the establishment of a professional, experienced board of directors with explicit fiduciary duties to the government shareholder, as well as executive compensation linked to clear performance standards, among other standard business structures. Importantly, it also includes the legal creation (but not the sale) of ownership shares in the firm. All shares are initially held by a single government shareholder, such as the U.S. Treasury.

By better focusing the Postal Service's goals, this step would improve firm governance. This initial governance step is a straightforward extension of the 1970 Act in that it provides the necessary legal framework to allow the Postal Service to become more businesslike, and to take better advantage of market opportunities as they appear in this dynamic sector. An improved legal framework, board structure, and organizational focus would also help the Postal Service to attract managerial talent with experience in a changing delivery sector. Managers could be drawn from overseas where other countries have many years of experience with a postal liberalization. Moreover, it would help create the focused incentives necessary to compete in today's increasingly competitive delivery marketplace.

Although they are distinct, corporatization and privatization are related. Privatization refers to the actual offering of ownership shares to the public once they are legally created. That is, the Treasury would divest itself of its ownership shares, typically over time in tranches. The first sale of shares would constitute an "initial public offering" of Postal Service ownership shares.

There are large, often underappreciated, social benefits associated with such a step. First, the Postal Service would receive an influx of much-needed capital that would allow it to undertake innovative, but inherently risky, new approaches in the postal and delivery sector. The burden of providing the capital necessary for such innovation thus would not come from taxpayers, but instead from private investors.

Second, the risks inherent in moving from the current fiscal crisis to creating a vibrant, profitable, sustainable postal sector would be borne by investors rather than by taxpayers. In addition to providing capital, private investors offer the service of bearing the lion's share of the risks inherent in developing a sustainable postal sector in the United States. As in the provision of any service, investors do not provide risk-bearing services for free. They instead place their capital at risk only when they are reasonably assured of earning a return on that investment commensurate with the risks they expect to assume.

Third, allowing ownership shares to trade further improves firm governance. Tradability generates a stock price, which provides a clear, transparent, constantly updated signal regarding the quality of managerial performance. This helps improve governance because performance is more easily observable. The existence of a stock price also allows the board to tie managerial incentives directly to performance through such compensation methods as stock options, restricted stock, and bonuses linked to stock price movements relative to some benchmark, among other governance mechanisms.

Because of these and a range of other social benefits associated with tradable ownership shares, the most appropriate organizational structure for a large commercial entity such as the Postal Service is likely to be a publicly traded company. This stems from the large capital needs and inherent risks associated with operating an innovative delivery business.

It is important to note that the above reforms are compatible with ensuring universal delivery service. Indeed, it is likely that the Postal Service's current structure may be hindering its ability to ensure universal service, as the recent plan to reduce Saturday delivery service suggests. Although a complete discussion is outside of the scope of this testimony, postal liberalization can in fact facilitate universal service through a route-bidding approach.² This approach allows several firms to compete for the right to provide service on a particular route. If the route is money losing, then firms can compete on the basis of the lowest acceptable subsidy required to provide universal service. Rather than a radical departure from current policy, this represents an extension of current practice under which the Postal Service contracts with private firms to deliver mail on some sparsely populated routes.

² I have outlined this approach elsewhere.

International Experience

The United States now lags behind almost every other developed country in postal liberalization. All 27 members of the European Union have eliminated their postal monopolies. New Zealand repealed its delivery monopoly in 1998. Sweden repealed in 2003. Germany and the Netherlands repealed in 2007 and 2009, respectively. The threat of competition associated with monopoly repeal has helped postal services in those countries to become more efficient, more effective enterprises.

Other countries are also far ahead on organizational reforms. Germany's post -- now Deutsche Post DHL -- was privatized in 2005 and has become a major player in the global delivery and logistics business. It reformed its compensation structure, brought in managers from other sectors, and modernized its delivery network. It operates in 220 countries and is now the world's largest courier company.

The UK post -- Royal Mail -- will be privatized later this year. One hundred percent of the formerly government-owned post in the Netherlands is now privately owned. New Zealand Post was corporatized in 1987, while all government subsidies were eliminated in 1988. New Zealand Post has become a successful, innovative global company focusing on parcel delivery, logistics and other businesses.

Summary and Conclusions

Recent, rapid declines in the Postal Service's core function of delivering first-class letters have continued to occur despite a recovering economy. This suggests that increasing use of electronic substitutes for physical mail, such as phone calls, faxes, e-mails, and text messaging, are eating away at the demand for first-class mail, the Service's core and most profitable offering. This has also reduced revenue from first-class mail. Given its relatively high cost structure, it is unsurprising that the Postal Service is in the midst of a major financial crisis.

Unlike other industries that have faced threats from new technologies over the past century, the experience from other countries suggests that the postal sector in the United States can become a vital, innovative, and sustainable part of the economy. For this to occur, however, it is imperative that the U.S. postal sector be liberated from its government-owned, monopoly structure. Rather than representing a sharp departure from the past, such reforms are a logical extension of the changes contained in the 1970 Postal Reorganization Act that created the Postal Service.

The U.S. Postal Service has an enormously valuable asset in its universal delivery network that has been constructed over decades. That asset deserves to be managed as effectively as possible. The reforms outlined above will ensure that the Postal Service remains a sustainable, vigorous institution for decades to come.

Figure 1. First-Class Mail Volume

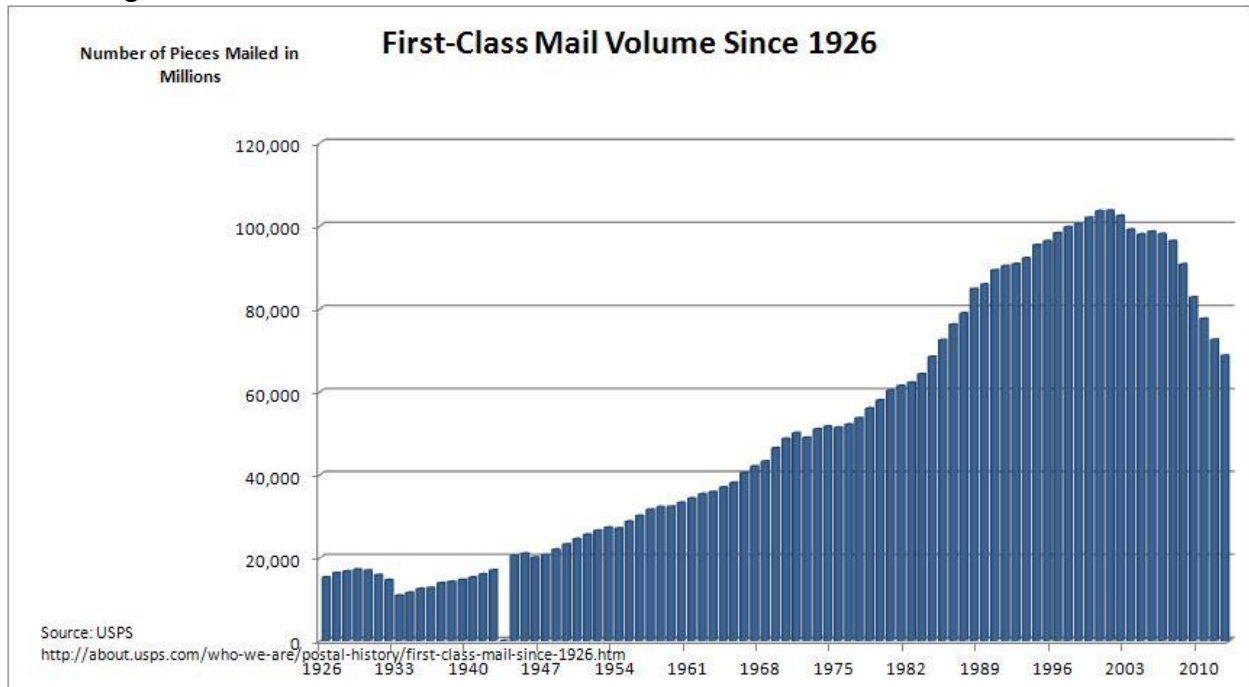


Figure 2: Operating Cost per Piece of Mail

