Postal Reform for the Digital Age

BY ROBERT D. ATKINSON | JUNE 2013

Now is time for far-reaching Postal reform and in particular to evolve USPS to focus almost exclusively on its true core competence: delivering the mail in the "final mile," while opening up the rest of the system to robust private sector competition.

The United States Postal Service (USPS) has reached a critical point, where it has exhausted its $15 billion borrowing authority from the federal government and is hemorrhaging billions of dollars per year. And while Congress is debating postal reform to respond to the crisis, the issue is not new. I wrote about this in 2001 when Congress was also considering postal reform that led to the Postal Reform Act of 2006.[1] But then the crisis was only anticipated, not realized. I and others warned that with the migration to digital communications that absent serious structural reform, the future of USPS was dire.

The 2006 reform was a step in the right direction but was not enough. Now is time for far-reaching Postal reform and in particular to evolve USPS to focus almost exclusively on its true core competence: delivering the mail in the "final mile," while opening up the rest of the system to robust private sector competition.

The Internet has enabled new business models that have disrupted and even destroyed incumbent models. From travel agencies to video rental stores, the Internet has transformed industries, resulting in higher productivity, greater consumer choice, and lower prices. These industries have one thing in common: they provide information-based services. It should come as no surprise then that the United States Postal Service (USPS) is facing massive challenges. For, like many other industries whose business models made sense in an analog, paper-based era, USPS's business model makes much less sense in today's digital era and as such is in need of fundamental reform.

The need for change could not be clearer. USPS has lost almost $30 billion dollars in the last three fiscal years and is on track to lose billions again in 2013. The cause is also clear. Mail volume, especially the most profitable first class mail, is down, while delivery points are up. And while some of the decline is due to the slow economy in the aftermath of the Great Recession, most is due to the switch from paper to digital (e.g., electronic bill delivery and payment). In response to this crisis at least five major approaches for USPS have been proposed:

1. Muddle through and hope things will get better. This is the current approach, favored by many in Congress. However, muddling through will likely fail, as the shift from paper to electrons (for mail, not packages) is inexorable.

2. Increase USPS revenues through either subsidies or new lines of business. Many defenders of USPS, including some mailers, the paper and letter industry, and the postal unions, want taxpayers to bail out USPS. If USPS revenues are declining and costs can't be cut, it's incumbent on the government, they argue, to fill the gap—either through letting USPS off the hook for its retirement fund obligations or by outright general fund subsidies. Not only is this bad economic policy—subsidizing one kind of activity (physical mail) but not its competitor (e-mail), but in an era of deep and chronic budget deficits it's not realistic. Likewise, the potential for USPS to make supranormal profits in new lines of business to transfer to its money-losing mail business is limited.

3. Keep the existing structure but enable increased efficiencies. This would include Congress giving USPS more flexibility in closing facilities, dealing with union demands, and reducing delivery days. These steps would help, but they wouldn't get to the fundamental problem of lack of adequate competition for most USPS functions.

4. Privatize and open USPS up to competition, including lifting the first class letter and mailbox monopoly and letting USPS enter other lines of business. While more competition is needed in upstream mail functions, privatizing final mile delivery—a natural monopoly—would increase, not reduce mail delivery costs.

5. Focus USPS on delivery of mail to the "final mile." In this model, the Postal Regulatory Commission would approve a price which USPS would charge to deliver mail to the last mile. Private competitors would then be free to compete for all upstream functions, including collection, transportation, and processing. As part of this solution, Congress would also need to give USPS the authority to close post offices, sorting facilities and other facilities, to layoff postal workers, and to choose how many days a week to deliver mail. ITIF believes that this approach offers the best chance for preserving a postal system without costly subsidies.

INTRODUCTION

USPS is a massive organization and a major part of the U.S. economy. With nearly 500,000 employees, it employs more people than Chrysler, Ford, and General Motors combined. It delivers billions of pieces of mail to over 152 million addresses every year. With annual revenue of $65 billion, USPS ranks as the 42nd largest global corporation on the Fortune 500 list.[2]

But USPS is no ordinary business enterprise. It is sui generis: a government entity that provides a commercial service, has no shareholders, and pays no taxes. It is also an entity controlled by Congress with limited ability to make needed changes.

Even before the Great Recession, the Postal Service's core business faced a serious threat: the Internet. Digital services such as e-mail and electronic bill payment have caused significant declines in the Postal Service's most profitable categories of mail, and online marketing gets relatively more effective as more people spend more time online. These trends will only continue as more Americans get online and become more comfortable with Internet transactions, and as new devices like e-book readers and smart phones become ubiquitous.

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The bottom line: USPS is hemorrhaging money and is insolvent. As such, substantial and fundamental reform is needed to allow USPS to survive in the digital era. The objectives of any postal reform effort are relatively straightforward: cut costs by bringing the benefits of competition to the postal system to the greatest extent possible, all while preserving universal delivery and the letter delivery monopoly.

The primary goal of any serious reform effort should not be to preserve USPS as an organization or even to straighten out its finances, but to create the lowest cost, highest quality public and private postal system. Subsidizing the physical mail business by allowing USPS to enter other areas of business is neither appropriate nor likely to succeed. Subsidizing USPS directly from the general fund is likewise not appropriate and in a time of fiscal crisis unwise and unlikely. Complete privatization schemes, on the other hand, are not workable, particularly if the United States is to remain committed to universal postal service.

Rather the focus should be on modernizing the entire postal system. This report offers a plan that would preserve the USPS monopoly on "final mile" delivery while opening up the collection, transport, sorting, and processing of the mail to much greater competition. In this model, customers will be able to send mail from local stores instead of the local post office and private companies will sort and transport much more of the mail faster and more cheaply, all the while USPS does what it excels at: delivering mail to over 150 million U.S. households and businesses.

This kind of reform will require changes in how we all think about USPS and the postal system. It will mean that USPS will have to cut its workforce even more substantially, but there is no fixed law that says USPS must employ nearly half a million Americans. It will also bring uncertainty and risk to the postal system, and some new players in the postal system will surely fail. Though we should not put our faith in USPS or any particular competitor, we should have faith that competition will lead to a better, more efficient system, and that competition will spark innovation and new competitors.

To that end, ITIF recommends that the rules governing the postal system be changed to give greater incentives to private entities to more efficiently compete in larger portions of the postal value chain. To ensure that this new competitive mandate is carried out fairly and in time to save USPS from completely going under, Congress should act soon. Specifically, Congress should do two things:

- Require USPS to work with the Postal Regulatory Commission (PRC) to set a delivery price at which they will accept all mail for final route sort and delivery.

- Give USPS the authority to close facilities, including local post offices to reduce delivery days, and to lay off USPS workers without having to provide large severance or retirement packages.

BACKGROUND OF THE POSTAL SERVICE

The U.S. Postal Service has played a significant role in the development of the United States dating back to colonial times. The Second Continental Congress established the forerunner to the modern Postal Service, appointing Benjamin Franklin to be the first postmaster general in 1775. In the more than two centuries since, the Postal Service (known previously as the Post Office and the Post Office Department) served as the primary means of communication between citizens and businesses in the far-flung colonies, states, and territories.

For most of that history, the Postal Service has operated under the Private Express Statutes, which give it a monopoly on the delivery of letters over postal routes.[3] In 1934, Congress also granted a monopoly on access to mailboxes, making it illegal to deliver any item to a mailbox or mail slot without paying postage. The Postal Service has five major classes of mail including First-Class, Standard (commercial or advertising mail), Shipping and Packages, Periodicals, and International Mail. Standard and First-Class Mail generate the largest revenue stream, comprising 83 percent of total mail delivered and 67 percent of mail revenue.

Though the Post Office played a vital role, it was hampered by decades of political patronage, mismanagement, labor unrest, and graft. The Post Office reached a crisis point in the mid-1960s, typified by a delivery strike in Chicago in 1966. In 1969, Congress began looking at ways to fix the Post Office, and the Postal Reorganization Act took shape. Under that proposal, the Post Office would no longer be a Cabinet-level agency, but an independent executive agency with a mission to maintain universal service and to operate on a break-even basis.[4] In August 1970, President Nixon signed the Postal Reorganization Act, and the Post Office Department became the U.S. Postal Service—not a government corporation but an "independent establishment in the executive branch." Thirty-six years later Congress passed the Postal Accountability and Enhancement Act which reformed rate setting, introduced stronger limits on USPS vis-à-vis unfair competition with the private sector, strengthened the role of the Postal Regulatory Commission, and required USPS to pre-pay retirement funds.[5]

While USPS was able to perform adequately financially (in part because postal rates increased 27 percent after the 1970 Act) until the mid-2000s, in the last decade, the Internet has eaten into demand for physical mail as the movement of bits is displacing movement of atoms. From 2001 to 2012, mail volume fell 23 percent, with the most profitable first class mail volume falling by 34 percent.[6] (see Figure 1) And in the last year mail volume declined an additional 1.5 percent, with all of the loss and more in the most profitable first class mail.

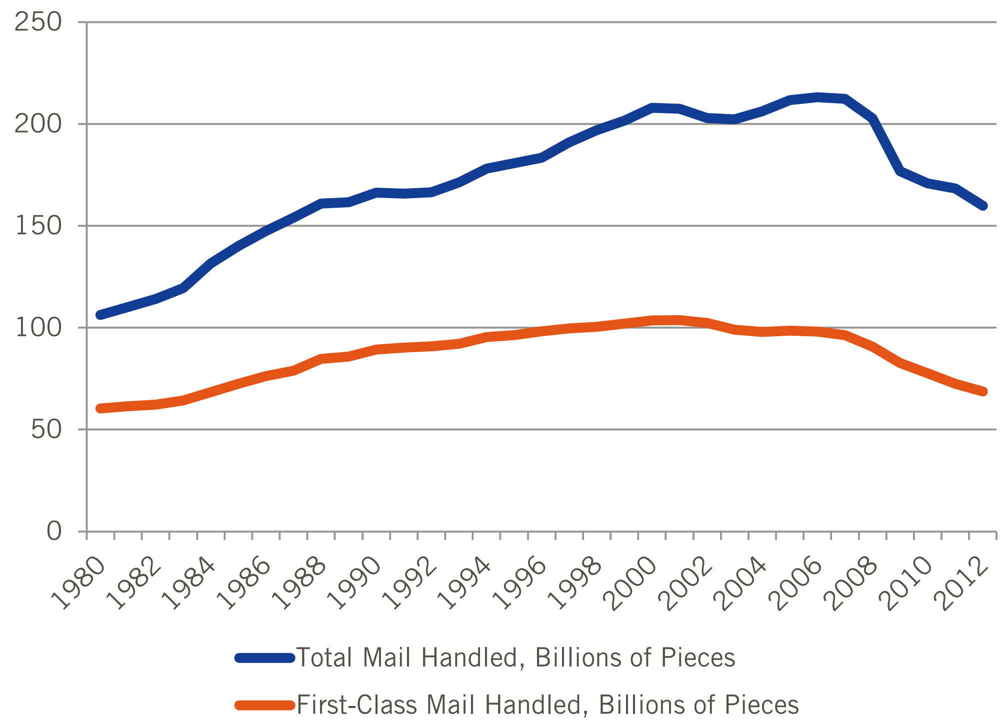

Figure 1: Trends in USPS Mail Volume[7]

At the same time, the number of delivery points USPS must deliver to has increased 13 percent since 2001, while the number of post offices has fallen by just 4 percent. (see Figure 2) However, USPS has been able to shed some workers in response to declining mail volumes, with workers declining by 32 percent since 2001, but still above 1978 levels. (see Figure 3)

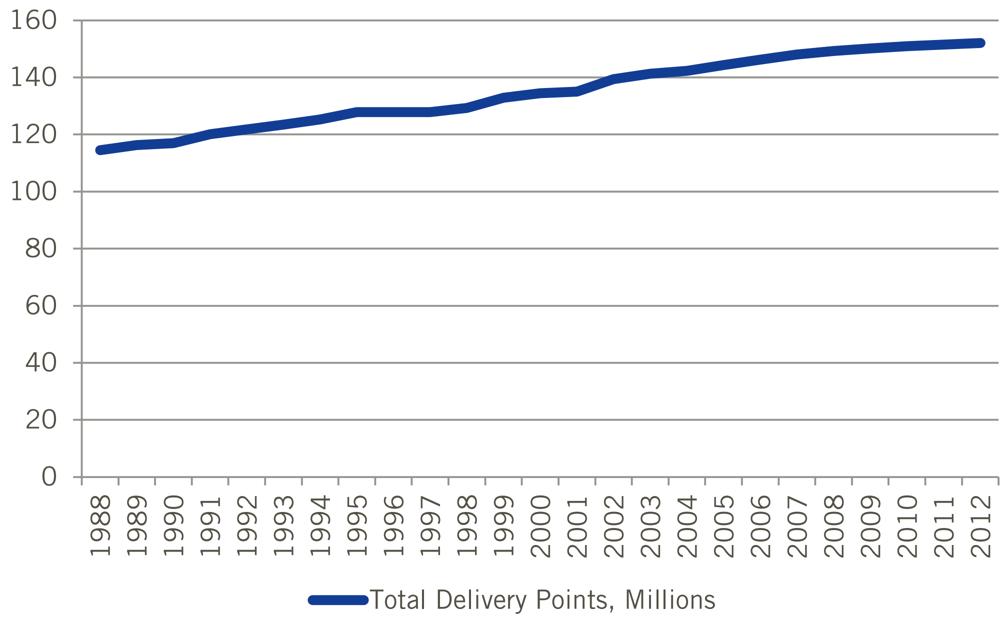

Figure 2: USPS Delivery Points[8]

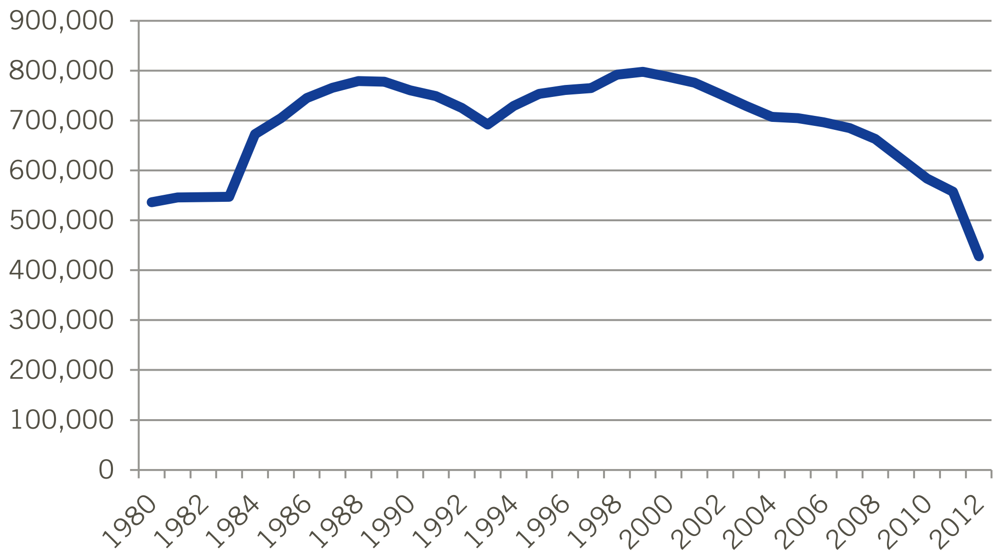

Figure 3: USPS Employment[9]

As a result, USPS income in constant dollars is lower today than it was in 1986, with its income peaking in 2003. (see Figure 4) In contrast, its expenses (in constant dollars) peaked in 2007, and today are higher than in 1997. (see Figure 5)

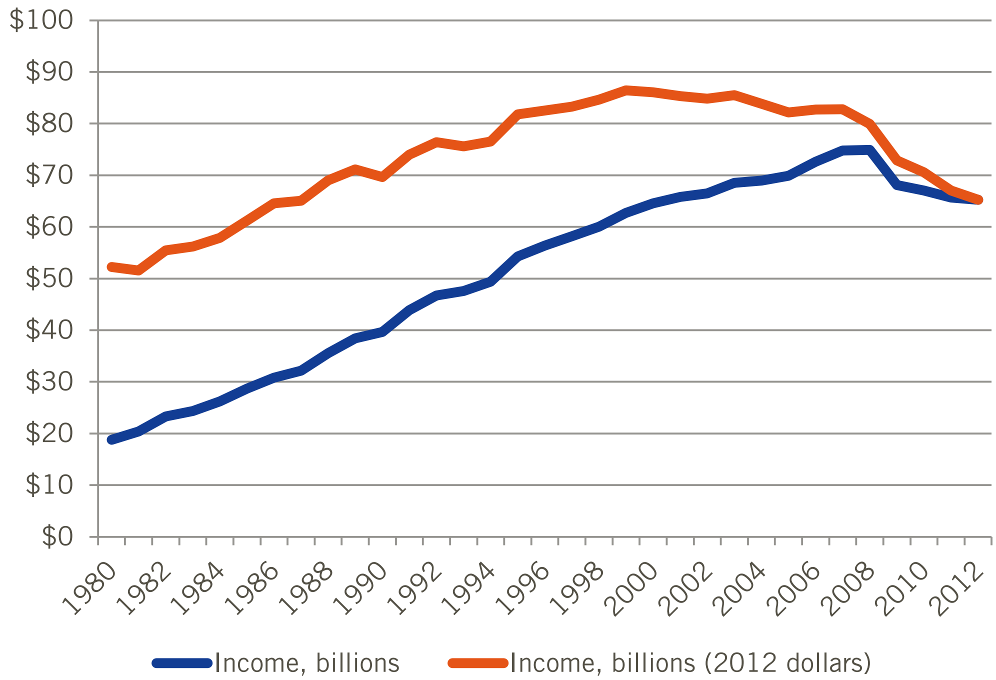

Figure 4: USPS Income[10]

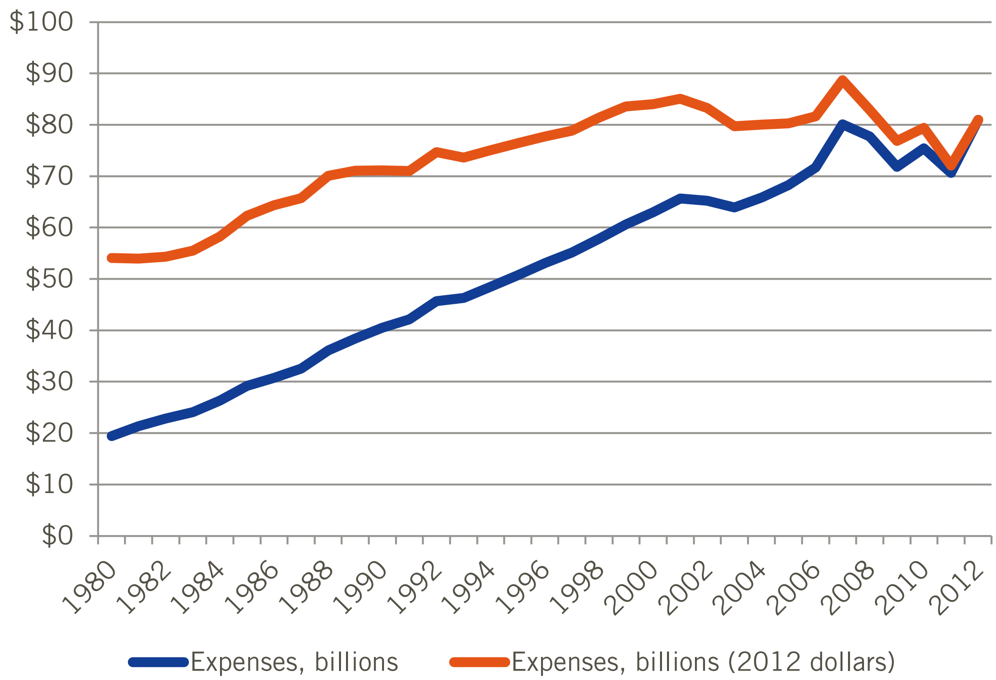

Figure 5: USPS Expenses[11]

As a result, USPS has been hemorrhaging money. From 2007 to 2012, USPS has lost over $44 billion in constant 2012 dollars, with an unprecedented loss of $16 billion in 2012. In the first quarter of 2013, USPS posted a net loss of $1.9 billion, with $16.3 billion in revenues and $18.2 billion of expenses.[12] (see Figure 6)

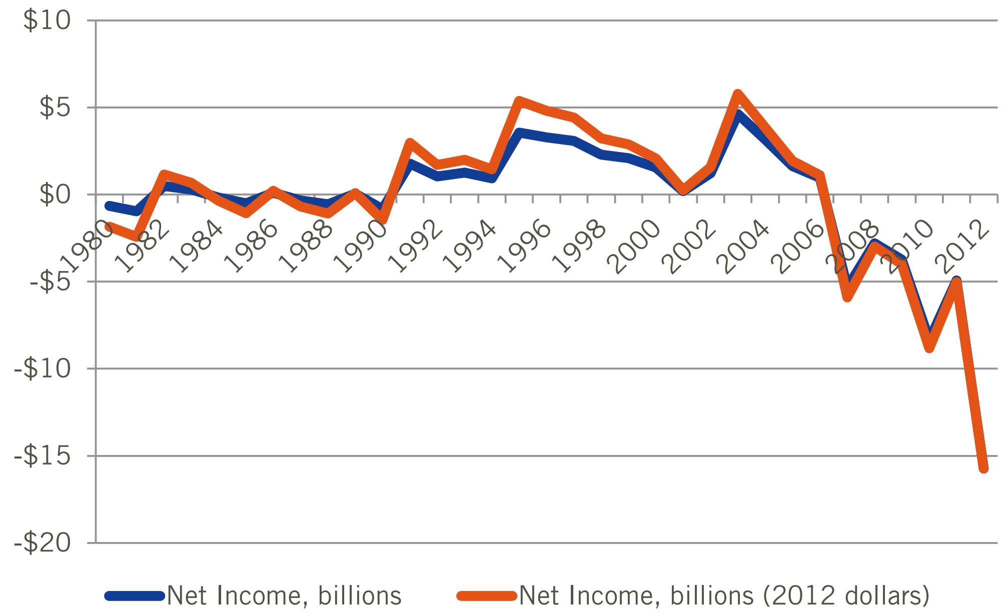

Figure 6: USPS Net Income[13]

As mail volumes decline, either USPS must become more efficient and downsize or postage rates must be increased. However, if postage rates increase, the incentive to move toward Internet-based communications increases both for first class mail (e.g., to electronic bill payment) and standard mail (e.g., to online marketing). In fact, the "elasticity of demand" for postal services may be higher than it once was, precisely because senders now have more choices.[14] Higher rates could create a self-reinforcing downward spiral whereby as rates go up volume goes down, requiring even higher rate increases, etc. If rates do increase, the "death spiral" will continue until a new point of equilibrium is reached, but it is impossible to foresee where that point will be.

How Did This Happen?

On its face, USPS's challenge is that the organization is bleeding money while providing a service that is not keeping pace with technological change. But the underlying cause stems from the fact that USPS was established as a nationwide organization to collect, transport and deliver information that was embedded in paper and we have moved on to a world in which information increasingly travels on electronic networks provided by the private sector.

Declining Mail Volumes

While USPS competes with UPS and FedEx, its real competitors are companies like Apple, AT&T, Google, Microsoft, Yahoo, and Verizon, or more accurately e-mail, broadband, and computers. In other words, USPS is competing against digital communications. And it is losing.

The biggest problem facing USPS is the decline in first class mail due to electronic diversion. First class mail is one of the largest contributors to the overhead costs of USPS, but volumes have declined. In 2012 first class mail generated 44 percent of USPS revenue and accounted for 42 percent of volume, while standard mail accounted for 50 percent of volume, but only 25 percent of revenues. While first class mail volume grew 48 percent in the 1980s, its growth slowed in the 1990s (16 percent) and declined in the 2000s (-25 percent), with another 12 percent decline from 2010 to 2012.[15] Total mail volume declined less, but still 23 percent since 2000.

This decline is due in large measure to advances in the Internet. The share of American households with broadband Internet access went from less than 5 percent in 2000 to over 90 percent today, with 96 percent of households having wireline broadband networks available for them.[16] Approximately 70 percent of households have computers, while over 40 percent have smart phones.[17] Over 70 percent of the adult population uses e-mail and half pay their bills online.[18] Evite, which allows people to send electronic invitations (instead of the traditional birthday card party invite, for example) has over 15 million unique users every month, while "Facebook events" lets Facebook users send Internet invitations.[19]

In short, digital technology is likely to lead to a continued decline in paper mail, especially the first class mail that contributes most to the overhead costs of USPS.

Moreover, as Internet technology will only get better and more ubiquitous in years to come, these percentages can be expected to increase over the next decade. Wireline and wireless broadband speeds continue to improve. Over just the last year, average U.S. broadband speeds have increased by 25 percent.[20] The new 4G LTE wireless network, which provides speeds five to ten times faster than the older 3G networks, is now available to 90 percent of U.S. households. And social network use has exploded, with worldwide Facebook users growing from 12 million in 2006 to over a billion today.

Online advertising has also increased, growing from $7.3 billion in 2003 to $36.6 billion in 2012,[21] and it is expected to continue to grow by 17 percent over the next few years.[22] And while direct mail has a better response rate than e-mail, its response rate has declined 25 percent in the last nine years.[23] Moreover, e-mail advertising, while having a lower response rate, has a four times higher return on investment than direct mail.[24] And social networks continue to grow as an advertising platform. In 2012, 85 percent of B2B marketers used LinkedIn to market their products or services 2012.[25]

In addition, with the increased adoption of e-book readers and tablets and increased functionality for displaying magazines, paper magazine subscriptions could very well decline over the next decade. It's easy to forget that the first Apple iPad was released just three years ago. Today, one-third of Americans own either a tablet or e-book reader.[26] And while many thought that services like Netflix DVDs by mail would turn around USPS mail volume declines, it's clear that the days of that particular business model are limited as more Americans turn to digital downloads.[27]

And the trends are likely to continue, one reason is generational. Younger cohorts are less likely to rely on the physical mail and more likely to embrace digital alternatives. This is one reason why the Boston Consulting, for example, predicts that mail volumes may decline 34 percent from 2009 to 2020, with virtually all the declines coming in the most profitable first class mail, where the portion of total margin available to cover fixed costs exceeds 70 percent, compared to just 21 percent for standard mail.[28] In short, digital technology is likely to lead to a continued decline in paper mail, especially the first class mail that contributes most to the overhead costs of USPS.

Difficulty in Cutting Costs

With powerful unions and Congressional mandates standing in the way, USPS has found it hard to cut costs to the extent needed. Postal unions have historically resisted changes that could decrease costs. For example, union opposition slowed USPS from installing automated machines in the lobbies of postal stations that could weigh parcels, determine the postage due, and print the postage stickers so customers could affix them and drop them off in the outgoing mail bins. Moreover, because the unions are so powerful, postal employees are able to extract a wage premium over their private sector counterparts.[29]

Another serious problem is interference by Congress. Congress has stretched the universal service obligation from simply requiring that USPS serve every mailing address to mandating levels of service. For example, USPS is prohibited by statute from closing any of the 37,000 postal stations for poor financial performance.[30] Congress also places a rider on the annual postal appropriations bill that prohibits USPS from reducing service; this forecloses several options that could contribute to cost savings, such as cutting delivery to five days per week or requiring some customers to move their mailboxes from the front door to the curb.[31] USPS recently proposed shifting to five day a week delivery, arguing it would save as much as $3.5 billion per year, but backed off after concluding they do not have the authority to do so and as Congress voiced its opposition. Although the intent of Congress is to prevent USPS from cutting service to disadvantaged and rural areas, the effect is to saddle the postal system with high costs that result in massive losses. Members of Congress have also intervened to prevent the closure or relocation of postal data-processing and mail-processing centers, making it more difficult for USPS to cut costs while maintaining service levels for end customers.

The result is that USPS has too many post offices and sorting facilities. For example, Robert Cohen, Luigi di Paulo, Renee Sheehy and Vincenzo Visco Comandini find that "the distribution of post offices is very different than it would be if post offices were distributed on the basis of market forces."[32] In the mid-2000s, 51 percent of post offices were located in rural areas, compared to only 12 percent of U.S. pharmacies or bank branches.

Proposals to Fix USPS

There is no shortage of proposals to fix USPS. The Postal Accountability and Enhancement Act of 2006 allowed for some progress to be made but nowhere near enough. Congress is debating another round of postal reform, but with significantly different approaches from the House and the Senate. In addition, many stakeholders, advocates and scholars have proposed an array of solutions. These solutions can be classified into two types: proposals to allow USPS to increase revenue and those designed to allow it to cut costs.

Proposals to Increase USPS Revenues

USPS can address its fiscal woes by either cutting costs or increasing revenue (or doing both). For many, increasing revenue is the preferred option, in part because it avoids having to deal with politically tough questions of downsizing. There are two major ways USPS can increase revenue: get government subsidies or enter new lines of business. Neither represents a viable strategy.

Subsidies

Some have called for the government to fund the USPS budget out of general funds. Cornell law professor Michael Dorf has argued that "so long as Congress believes that the Post Office fosters its goals of national unity through a connected populace, it should extend the Post Office a lifeline" in the form of a subsidy.[33] But Dorf goes on to admit that "given the long-term trends, it almost does not matter what form that lifeline takes. Any solution to the problems besetting the Post Office will necessarily be a stopgap." Postal analyst James I. Campbell has argued that the federal government should pay USPS for all costs not covered by commercial mail costs and expenses (e.g., universal service, retail facilities, etc.)[34] National Association of Letter Carrier president Fredric Rolando has argued that "to say that we must adhere to the post-1983 convention forever assumes that the taxpaying public receives no benefit from the Postal Service and therefore should never have to pay any of its costs. We believe this assumption is wrong—all Americans benefit from the Postal Services, taxpayers and ratepayers alike."[35]

And while USPS claims it does not want subsidies, the fact is that its efforts to convince Congress to let it off the hook for funding its retirement health obligations is in essence a call for a subsidy. USPS's failure in 2011 and 2012 to pay the $5.5 billion annual retiree health benefit prefunding payment represents a de facto subsidy from the federal government since when USPS eventually declares "bankruptcy"—which it likely will do absent serious reform—taxpayers will be on the hook to pay postal workers' retirement benefits.

Many groups, including USPS, have argued that the Postal Accountability and Enhancement Act of 2006 unfairly forces USPS to overfund retirement benefits of current and future employees. But a 2012 U.S. Government Accountability Office (GAO) study shows that if USPS were to go back to their pay-as-you-go approach to funding retiree health benefits it would increase its unfunded liability by as much as by $130 billion by 2040.[36]

There are three problems with subsidies. First, they are unfair. They are asking American taxpayers to subsidize either USPS workers or mailers. Second, they are inefficient. Economists justify subsidies if they respond to a market failure, especially one where an activity contributes positive externalities, or addresses an equity issue. But there is a compelling case that USPS provides no positive externalities and may even provide negative ones. Externalities are defined as the consequence of an economic activity that is experienced by unrelated third parties.

USPS and the Postal Regulatory Commission (PRC) have tried to argue that there are significant social benefits from USPS. For example, a recent report by the Urban Institute supported by the PRC identified "dozens of benefits" in eight broad categories.[37] But most of these benefits were ones that customers received in exchange for paying for postal services, not externalities, such as delivering voting by mail ballots and being able to apply for passports by mail. And the benefits they did identify as externalities, such as environmental benefits, are not really externalities since they include things like "USPS reduces gasoline consumption by mapping out energy-efficient routes," or "mail accounts for less than 5 percent of all municipal waste" or "some post offices are drop-off points for recycling cell phones."[38] These are not externalities.

As such there is little evidence that individuals other than senders and receivers of mail receive a benefit from USPS. Indeed, one could argue that society pays a cost for this, with excessive advertising (which is largely a zero-sum activity that only changes which company gets a sale, not overall sales), and increased air pollution and greenhouse gas emissions from producing and delivering paper instead of electrons.[39] In contrast, there is evidence that there are considerable positive externalities from the use of the Internet.[40] As such, partial subsidies would slow the inexorable shift to the Internet and the positive externalities from it. As some studies show, mail is now more price elastic than some initially thought, and commercial mail even more so.[41] As a result, increased prices and/or reduced service will lead to a shift to other modes with greater efficiencies and positive externalities.

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Third, there is no way that one can argue that allocating billions of taxpayer dollars to USPS would be a better investment for the nation than instead spending that money on activities like science, or education or transportation infrastructure that produce significant economic gains.[42] Morever, given the massive federal budget deficit, it is unlikely that Congress would support spending taxpayer money on USPS.

Rates Increases

The 2006 postal reform legislation prohibited USPS from increasing postal rates annually faster than increases in the Consumer Price Index (CPI) absent "exceptional or extraordinary circumstances." The logic of the legislation was that price caps would force USPS to cut costs. To some extent they have, but given that Congress limits USPS's ability to cut costs, the price caps have put USPS in a double bind. If Congress is not serious about fundamental reforms of the kind discussed below, there will be only two choices if it wants to avoid the complete financial collapse of USPS: subsidization, which as described above is an ill-advised idea, or rate increases. But while rate increases can help reduce the budget gap, they are not a long-term solution as they can increase the death spiral (higher rates mean less mail volume, which necessitate higher rates, and then less volume, etc.).

New Lines of Business

Perhaps the most popular recommendation for fixing USPS's financial crisis is to allow it to get into new lines of business. Current law limits USPS to selling postage stamps, stamped paper, cards and ancillary items. The theory is that if Congress lifts these restrictions that USPS can make significantly more money in other lines of business and that these profits will be so large that they will cross-subsidize its money-losing postal business.

The idea of USPS getting into new lines of business is not new. For years USPS has tried to raise revenue through various avenues other than delivery of mail. These products have been related to the primary mission of USPS to varying degrees. Some of the products were clearly not related to the primary mission, such as clothing and other products featuring images of stamps.Some products were tangentially related to the primary mission, such as packaging services and supplies.

In fact, past USPS entry into competitive product lines has largely failed. A decade ago GAO issued a report on the Postal Service's e-commerce initiatives.[43] The report showed that USPS ventures into electronic commerce were a mess: new product initiatives were launched without proper approval or oversight, and the financial records of the initiatives were so bad that it was impossible for GAO to determine whether USPS made or lost money on its efforts, let alone the amounts involved. For example, seeing that more and more Americans were using e-bill payment functions, USPS invested to get into the electronic bill payment function. Yet, most banks now provide this service for free to customers since it saves them money in not having to process paper checks.

But this has not stopped the idea from having a new life. MIT professor Michael Cusamano argues that:

> In the unrelated to mail category, financial services such as banking (savings accounts in particular, which are not costly to maintain) and insurance (such as simple term policies or product warrantees) come immediately to mind. The USPS could provide greater access to its infrastructure to other businesses as well as other government agencies, local, state, and national—a potentially enormous market. For example, postal workers could conduct the census as they deliver mail, or process and deliver official documents, such as licenses and inspection permits, perhaps while offering notary services. Postal workers could become meter readers where this is necessary, or help the elderly pay utility bills through mobile payment devices. The USPS could put advertising on trucks or allow mobile cellphone operators to mount antennas. The trucks could carry air quality monitoring equipment. The USPS could digitize and sort mail and then send it out electronically to customers who prefer not to have paper…there could be a service that lets only registered users store and send paper copies of photos, greeting cards, or postcards through the mail to other registered users after sending them to a USPS Web site. The USPS would then print the photos and cards (or subcontract the printing) according to customer instructions and then deliver them. Another service could be similar to the above but target secure documents, stored electronically and valid only when delivered in physical form (official copies of birth and death certificates, marriage licenses, divorce documents, stock certificates, deeds, permits, contracts, and so forth).[44]

More recently, USPS formed its Digital Solutions Group in May 2012 which is intended "to better explore growth opportunities in the digital space, and to translate those opportunities into new streams of revenue, enhance the value of our current offerings, and improve customer experiences."[45] Likewise, in a report that proposes that USPS enter the e-government business, the USPS Office of Inspector General stated that “the Postal Service could provide a community service by designating Post Offices in underserved areas as access points or broadband hotspots, offering wireless access to the public.”[46] They go on to propose that “interested citizens could use kiosks to look up information on applicable laws and regulations, submit federal loan applications, have their identities authenticated, attach electronic signatures, and file all required paperwork in digital or physical form. The Small Business Administration could potentially lease excess window space in postal retail locations throughout the country to have their agents available to assist citizens in a cost effective manner.”[47]

At first glance, allowing USPS to get into other lines of business seems appealing: the Postal Service is facing an annual deficit of billions of dollars, and a debt of billions more. As new technologies decrease the need for physical mail, it is becoming clear that the Postal Service will have to either cut costs or implement significant rate hikes. Allowing USPS to get into non-postal businesses and earn profits will alleviate the pressure for rate hikes or taxpayer bailouts. Moreover, it sounds like a good way to increase efficiency, especially for those product lines that are related to its primary mission: the local post office is right there, they have extra room in the lobby, why not use it to sell boxes and bubble wrap? Or use the USPS trucks to deliver pizza in the evenings?

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There are two problems with this line of thinking. The first is that it’s not as if there are numerous profitable activities sitting fallow just waiting for USPS to find them. Banks already provide banking service. Clothing companies make clothes. Internet companies provide e-mail services. The notion that USPS could make supranormal profits in these new lines of business large enough to bail out its money-losing mail delivery line of business is dubious at best. For example, there is no evidence that USPS could make any money from providing broadband wireless hotspots, given that companies like Starbucks and many broadband providers offer it for free to their customers. Other ideas like storing documents electronically and then delivering them or reading meters are likely at best to have very short product lives (if they can live at all) as America transitions to full electronic documents and smart meters. And there is no evidence that consumers are willing to pay for services like getting an e-mail address linked to their physical addresses, and if they were, why existing e-mail providers would not already provide this service. In short, the potential of generating billions of dollars in profits from these activities to compensate for ongoing postal losses is improbable at best.

The second problem is that non-postal products and services are commercial enterprises, and the Postal Service is a government entity. It is not appropriate for USPS to expand its charter past the basic function of delivering physical mail to competing with private enterprises in electronic bill payment, e-mail, provision of Internet service, retail sales, or any other private enterprise. It is proper for government to consider providing services only when there is a natural monopoly, where there is a significant public goods justification (as there is with National Public Radio, for instance), or when equity considerations are involved. But many of the businesses USPS has tried to start, like the Internet businesses or a clothing line with the USPS brand, do not meet this test.[48]

Because USPS sees its mission as binding the nation together, postal executives seem to believe that their function is the movement of information. It is not. The function of the Postal Service is to move physical mail; the Postal Service should move atoms, not bits. Last mile delivery of mail may be a natural monopoly, but there is no natural monopoly in the movement of information, and certainly no monopoly in the provision of information-related services, such as electronic billing, tax preparation, or providing Internet access. This is not to say that USPS should have no Internet presence whatsoever. On the contrary, USPS should expand into Internet enhancements of its mail service, such as online package tracking, or perhaps using GPS on postal vehicles.[49] But these business opportunities and the profits from them are likely to be limited.

Proposals to Cut Costs

As much as some might work to find ways to shift USPS to other lines of business, fundamentally USPS is in the business of delivering physical mail. Everything else is ancillary. As such, with declining mail volumes the only real path to sustainability is to cut costs. There are two paths to cost cutting, an incremental path and a more transformative path.

Incremental Cost Cutting

One of the largest single factors that prevents USPS from cutting costs is Congress. Because of language in Title 39 of the U.S. Code, and a perennial rider to the Treasury and Postal Appropriations bill, USPS is prohibited by law from making changes that could save billions of dollars a year. But according to the GAO, USPS has not reduced its retail postal and mail processing facilities enough to match declining volumes.[50] If the postal system is going to be preserved, USPS will need to be able to close facilities and reduce the frequency of mail delivery.

One easy change would be to give USPS the authority to close those postal stations where other alternatives are available, particularly those with operating costs far out of line with the number of customers served. Many unnecessary postal stations are in urban areas, where other postal stations are available within a few miles or even within a few blocks. There is no reason that these stations cannot be closed.[51]

Moreover, if the mail collection function is opened more widely to competition, as we suggest below, the number of postal facilities that could be closed would be even larger, since private alternatives (e.g., Mail Boxes Etc. or the local grocery store) could take their place. There may be some postal stations that must remain open, even though they are not economically justifiable, either because customers have no other easy alternatives (e.g., private companies have not stepped forward to provide postal services) or because the facilities are key to the logistics of universal delivery. However, USPS should have the power to make those decisions based on its needs and financial situation.

Likewise, Congress should allow USPS to close mail processing facilities. Holding to the idea that USPS is a jobs program for postal workers living in particular congressional districts means that USPS will continue to hemorrhage money. Closing facilities would have the added advantage of reducing mail-related air pollution emissions. Allowing USPS to close unneeded facilities could reduce CO2 emissions by 15 percent.[52]

Savings could also come from reducing deliveries from six days a week. Depending on the future trends in postal volume, USPS may need to evolve to a three day a week delivery system (Monday, Wednesday, and Friday for some routes and Tuesday, Thursday and Saturday for others). The potential for cost savings in labor are obvious, but fewer delivery days could save in other ways as well, such as reducing maintenance and replacement costs on delivery vehicles. Given that over 90 percent of mail is business mail (either marketing or bills) that can for the most part tolerate an extra day of delivery time, the idea that reducing mail delivery, even to 3 days a week, would lead to significant consumer harm is far-fetched. Granted, package delivery is somewhat different, since it is often competing against the convenience of going to a local store yet some will argue that six days a week is sufficient. If frequent delivery is so important why don't we institute twice a day delivery as they did in London in the 1800s? The answer is because it would cost significantly more. Most Americans (70 percent) in fact support reduced delivery, at least to five days a week.[53] And those who oppose it may do so because they do not believe they are actually bearing the costs of six day a week delivery. But if they were to be asked, "would you rather pay $50 dollars per year extra and get six day a week delivery or save the $50 and get 3 day a week delivery," it's likely most Americans would take the $50.[54] USPS should also be allowed to require the installation of curbside boxes at more homes, particularly in less densely populated suburban areas, which would cut the costs of mail delivery.

Finally, USPS could save money if it were allowed to more easily cut wages and/or benefits. This would require Congress to require arbitrators considering collective bargaining agreements to consider the Postal Service's current and projected financial condition.

These steps are important, but may not be enough, especially given the projected declines in postal volume. Therefore more compressive solutions are needed.

Full Privatization: A Step Too Far

One comprehensive reform solution that some advocate for is to privatize the Postal Service.[55] Their reasoning is simple: because no one within USPS stands to benefit directly if the organization becomes more efficient, gains market share, or offers new and innovative products and services, USPS has less incentive to fix its problems.[56] Privatization seeks to change that by creating "residual claimants," who can keep USPS profits for themselves. If USPS has owners or investors who stand to gain financially from improved efficiency and higher quality service, then improved efficiency and higher quality service are bound to follow, at least in theory.

If privatization is to work, many issues need to be resolved. Will the government retain a stake in the private corporation, and if so, will it be a minority or majority stake? Will the newly private corporation still benefit from the belief that the U.S. government will bail it out of any financial trouble?[57] Would foreign companies, including foreign postal services, be allowed to invest in a privatized USPS? Should USPS become employee-owned, thereby strengthening the performance incentive feed-back loop and possibly ameliorating the serious labor relations problems within the organization? How will USPS assets, which belong to the government, be valued so that the capital raised by privatization properly compensates taxpayers for the assets that they lose while maintaining a pool of capital to fund USPS needs going forward? Who will assume liabilities for future health benefits? Questions such as these constitute considerable, though not insurmountable, barriers to a workable privatization proposal.

Even if USPS is privatized, however, it cannot be set free from strong government control. While collection, processing, and transport of physical mail can efficiently sustain multiple firms competing for business, the "final mile" delivery of mail into mailboxes is a natural monopoly. The postal system has significant economies of scale that constitute high barriers to entry for other firms, including high fixed costs of final mile delivery, which accounts for more than one-third of total USPS costs. Analyses done by the staff at the Postal Rate Commission demonstrate how daunting the barriers can be: even if a competing firm could deliver the mail for 50 percent less per piece (due to lower labor costs and higher efficiency), and even if the firm delivered five days each week instead of six, the competitor would have to capture over 30 percent of the delivery market share just to break even.[58] Another analysis indicated that only 15 percent of total mail volume delivered to residences would be contestable by competing firms.[28] Having two carriers deliver mail to each neighborhood means increased total delivery costs.

Assuming that a privatized USPS would still be a natural monopoly, serious tensions would arise between the need to allow the private corporation to operate freely as a business and the need to strictly regulate its rates and business practices to ensure that no anticompetitive behavior arises. It is easy to imagine scenarios under which a privatized USPS might engage in anti-competitive behavior. A likely candidate would be expansion into "pre-postal" lines of business, such as printing catalogs or advertising flyers, and offering customers "turnkey" discounts, thus leveraging that early stage of the postal value chain with the end stage of delivery to recapture those parts of the value chain that have been lost to work-sharing.[59]

Absolute firewalls would also need to be established to ensure that monopoly profits do not subsidize competitive products and lead to predatory pricing. Of course, investors in a privatized USPS would likely chafe under the (inherently political) constraints on their business. On the other hand, investors could simply take a pass on investing in a privatized USPS that will be forced to operate under a constant dark cloud of anti-trust accusations, investigations, and lawsuits.

Privatization could also further weaken USPS's financial position because it would mean the end of indirect government subsidies. The Postal Service does not pay a host of taxes and fees faced by most corporations: income on its "profits", property taxes on facilities, registration fees for its delivery vehicles, or even parking tickets (which can cost other delivery firms millions of dollars each year). Other noncash subsidies include the ability to borrow from the U.S. Treasury and the power of eminent domain.[60] Given that USPS is already facing massive deficits, taking away these subsidies would only make things worse in the short term, even if a privatized USPS could experience rapid efficiency gains to counteract the additional costs. Again, investors may well be reluctant to buy into a corporation that is faced with dealing with this whole new set of financial and management issues.[61]

In the end, full privatization sounds better in theory than it would likely turn out in practice, even if the controversies over the mechanics of privatization could be magically resolved. Postal reform efforts should therefore focus on how to bring greater competition and efficiency to the upstream parts of the postal system while maintaining the USPS monopoly in last mile sorting and delivery.

Evolve USPS to a Last Mile Delivery Service

The reason for a government owned and operated Postal Service was two-fold—the nation needed an organization that would deliver mail to high and low cost locations and its functions were a natural monopoly. In fact, today only the last mile final sort and delivery is a natural monopoly. Other functions, such as collection, long-distance transportation, and processing are anything but natural monopolies and in fact have been opened up somewhat to competition. But having two or more companies do a final delivery sort to deliver the mail every day to the same houses (or different houses in the same neighborhood) is inherently inefficient. What used to take one mail person to deliver mail would now take two. So the right path forward for USPS is to specialize in what they do best and what is in fact the only remaining natural monopoly—last mile delivery.

So the right path forward for USPS is to specialize in what they do best and what is in fact the only remaining natural monopoly—last mile delivery.

There are two ways to do this: one based on subtraction of costs and the other based on addition. The subtraction cost method, which USPS has been engaged in for several decades, is known as work-sharing. Under work-sharing, USPS offers discounts to mailers who accept some of the functions that would otherwise be performed by postal employees. For example, the further a piece of mail is delivered into the postal system, the greater the discount. USPS has created special facilities to facilitate processing of mail taking advantage of lower rates. Discounts are also given for mass mailings that are presorted into carrier routes and placed in "walk sequence," so that no further sorting is necessary. These discounts are entirely appropriate and contribute to the overall efficiency of the postal system.[62] But USPS does not currently offer discounts for first class mail "drop shipped" at the local sortation plant.

While work-sharing provides useful incentives, it is premised on the notion that USPS remains in all parts of the mail processes functions and that it provides carefully calculated discounts to particular types of activities. Moreover, USPS tends to oppose efficiency-boosting incentives most strongly when mailers already have an incentive to increase efficiency on their own. For example, bundling bulk mail on pallets can generate significant efficiencies and savings for both mailers and USPS. But because many bulk mailers began using pallets for other reasons, USPS resisted giving back the savings in the form of a work-sharing discount, arguing that such a discount would not be an incentive since mailers were beginning to use pallets anyway. It may be true that the discount would be pure profit for mailers already using pallets, but the full pass-through of savings as a principle will not only encourage other mailers to start using pallets, but also encourage mailers to invest in other efficiency-boosting operations more quickly and more aggressively.

A simpler and more efficient alternative to work-sharing discounts is to provide a last mile delivery charge. USPS already does this for packages. More than 21 percent of FedEx deliveries are dropped off by a USPS postal carrier. Here, acceptance, sorting, and transport are done by the private sector, in this case FedEx, but delivery is done by USPS. This model should be extended to all mail, including first class mail. In this model, private sector providers in competition with one another would accept mail, process it, and transport it to local delivery areas. From there, USPS (or a designated contractor) would then sort the mail in address delivery order for the local postal dispatchperson to deliver. USPS would charge companies to deliver the mail based on their average costs for the entire delivery network and these rates would be set by the PRC.

Others have argued for this vision as well. For example, postal scholars Michael A. Crew and Paul R. Kleindorfer argue that “many of the upstream services such as collection, transportation, and mail process could be subjected to increased competition with local delivery remaining as a regulated monopoly. Postal administrations would provide only the local delivery networks and the sortation needed for local delivery.”[63]

This model would also encourage the evolution away from USPS-run post offices to ones run by the private sector. The Postal Service currently has two models by which the private sector can offer retail postal services: the Contract Postal Unit and the Village Post Office. A Contract Postal Unit is a retail postal facility located inside retail establishments, such as grocery stores and drug stores. The Village Post Office is similar in that it is a retail postal facility operated by a community business. The GAO found that these arrangements offer consumers greater convenience because of the additional locations and increased hours of operation.[64]

Imagine being able to mail a package from the checkout line at the grocery store, where a highly accurate scale is already available and a transaction is about to take place anyway. Mail could also be accepted at services like Mail Boxes Etc, at UPS, or even at drug stores, convenience stores, shopping malls, office supply stores, or any other place where senders might be going anyway. The address and postage could be printed onto stickers for parcels or onto standard-size envelopes that would overwrap cards and letters. The acceptor could sort (local and distant) and aggregate the mail contracts with private transport to deliver the mail directly to local sorting facilities. Many retail businesses would clamor to provide these services, as it is a way to attract customers to stores with very little initial investment for the provision of the service. Shifting the collection role to private companies could cut costs through more aggressive use of technology, while providing better service, more convenient locations, longer hours, and shorter lines.

Last mile sorting and delivery is a natural monopoly. The postal letter carrier cannot have two different bundles of route-ready mail. But there is no reason why the final delivery sorting function for each particular area could not be contracted out by USPS to private parties, provided there is only one final sort plant per delivery area. Last mile delivery should continue to be operated by USPS, however, in part because of the differences in costs between delivery areas and the need for universal delivery.

Key Questions to Resolve

As discussed above, a number of analysts and advocates have proposed evolving USPS to a last mile delivery service model. And to be sure, this would represent a significant change in operations for USPS. As such, a number of issues arise in response. In their review of a similar proposal authored by several postal thought leaders, the National Academies of Public Administration issued a report that addressed some of these issues.[65] Among these are:

Will this Proposal Improve the Fiscal Condition of USPS?

The most important question concerns whether a last mile would focus improve the fiscal condition of USPS. The National Academy's report had concerns that "executing the concept could negatively impact revenues."[66] It would negatively impact revenues because USPS would be exiting from much of the postal business, except principally for last mile functions. But because of this, it would also positively impact costs. The new focus would allow USPS to significantly shed costs, presuming that Congress gives it the flexibility to do so.

A related question is whether this proposal would enable the upstream functions to be conducted at a lower cost than having USPS conduct them. There is both evidence and logic to suggest this would be the case. For example, GAO found that contract postal units are significantly more cost-efficient, with costs of $0.17 for each dollar of revenue earned, compared to $0.51 cents in costs for each dollar earned by post offices.[67] This is only logical since these units are able to share the costs of space and labor with other functions, such as selling retail goods. In addition, as the National Academies argued, "private sector work rules are demonstrably more flexible than those currently in place for Postal Service career employees"—allowing private sector providers to better deploy new and more efficient technologies and to gain higher levels of productivity.[68] And some of the savings would also come from paying private sector wages and salaries, which are lower than USPS salaries. But the fact is that we don't have to be able to predict—in any kind of operations management way—whether this model of last mile delivery charge would allow the private sector to provide upstream postal services at a lower cost; if it does not, then the private sector will not enter the market.

Will the Private Sector Step Up?

Another related question is whether the private sector would take advantage of this opportunity for a public-private partnership. The National Academy report raises concerns: "Substantial capital outlays would likely be required of private sector mail processors as upstream operations shift away from the Postal Service exclusively to them. Not only would these expenditures for plant and equipment likely be sizable as an investment proposition, but they also may not be deemed very attractive as a long-term value proposition as mail volumes continue to decline."[69] Again this may be true, but it also may not be. One could imagine companies that already have existing distribution operations expanding into more mainstream postal products. But again, there is either value here or not, and the only way to find out is to set the last mile delivery charge and see what happens. If nothing happens, USPS would continue to provide its upstream functions. If the private sector does step up, by definition it will be at a lower cost and/or higher value than USPS provision.

Pricing and Universal Service Commitments

The key to this new model is the setting of the final mile delivery price. From an economic efficiency point of view, prices should usually reflect as closely as possible the costs of providing the service. Currently this is not the case. First class mail costs the same to deliver in the same town as it does to deliver it across the nation, or to deliver in a densely populated area or a thinly populated one. For business, non-first class mail, this is not always the case, as businesses can transport their mail across the nation and receive a work sharing discount.

So one question is whether the new model would evolve into a multiple price model depending on cost. In order to preserve the universal service obligation, the PRC should require USPS to charge single mailers one price for delivery, regardless of the delivery unit area. However, for routes that are significantly above the average cost to deliver to, USPS should have the right to alter the quality of service (e.g., fewer days of delivery per week, requiring curbside delivery, etc.). In addition, bulk mailers could be charged more for delivering to such areas and less for areas where delivery costs are less. For example, USPS could add a special last number zip code indicating cost of delivery (e.g., a "1" would be the cheapest, while a "5" might be the most expensive).

Another issue concerns what costs USPS could be allowed to recover through their "last mile" charge. Clearly it should be allowed to recover all the direct and indirect costs attributable to final sort and delivery, as well as costs to cover the related overhead. However, as the private sector gains more market share in upstream services, USPS costs would decline more slowly than its revenues due to the time lags and institutional inertia involved in reducing costs. As such, Congress might want to allow the PRC to allow USPS to also recover some small share of the other upstream USPS costs, with the provision that this additional charge would decline over a period of time to zero.

Other charges not set by USPS should be left up to the private sector. If private companies charge more than USPS charges, they may not obtain market share. If they charge less, it may be that some private postal units will establish differential pricing, charging more for "long distance" mail than for local. It's also important to remember that different local and long distance mailing rates are not unique. The United States in fact used to have a local and long distance price for mail before 1885 and from 1932 to 1944. Charging more for "long distance" mail and less for "local" mail would be more efficient, and while it might marginally reduce long distance mail, it might marginally increase local mail.

Transition Issues

If Congress were to require USPS to set a final mile delivery charge and accept all kinds of mail for final mile delivery, this transition to a public-private hybrid postal model would not happen overnight. As such there would be transition issues involved. For example, the National Academies worried that "there may be declines in performance due to waning morale as postal workers and mail handlers, who have a long and proud tradition as Postal Service employees, know that their future role in upstream operations will be phased out."[70] But this is not really a valid concern. Should upstream Postal Service workers lose morale and lower their productivity, this would only speed the transition to a more privatized upstream model. Moreover, if the privatized upstream model really is more efficient, not making the transition because of some short-term costs would end up costing the economy.

Another transition issue is what happens to upstream USPS workers. As in most private sector firms that face downsizing due to changing market conditions or poor firm performance, workers are not guaranteed income for life. USPS should be allowed to lay off postal workers, giving them notice under the WARN Act and some reasonable severance pay, but it should avoid generous early retirement packages as these make it harder to cut costs.

Arguments Against These Changes

Despite the possible benefits of this public-private model, some will argue against it, making a variety of claims.

USPS is Needed to Bind the Nation Together

This argument about the critical role of the Postal Service is akin to saying that we should preserve the horse and buggy industry because it once provided a key means of mobility.

Perhaps the most common criticism against shifting to a public-private model is that it runs counter to the very *raison d'être* of the Postal Service: to bind the nation together.[71] Defenders of USPS like to point to the importance of USPS in linking together a disparate nation in the early part of our nation's development. And consistent with this, the latest USPS annual report states that USPS "is as important to nation as ever."[72] It's hard to see how USPS is more important to the nation than it was in 1850 when we had no Internet, much less the telephone or telegraph. If USPS were to have disappeared then there would have been a clamor to recreate it. Today if it went away, the Republic would survive.

This argument about the critical role of the Postal Service is akin to saying that we should preserve the horse and buggy industry because it once provided a key means of mobility. Yes, it did, but now we have cars. USPS did once bind the nation together through communications, but technology evolves. And as technology evolves, the mission of USPS should not. Its mission should remain one of delivering letters to the last mile of all American households. It's not collection or transport. It's not e-mail. It's not operating branch banks, flower shops or food markets. And it's not selling clothes to "put the Postal Service on the cutting edge of functional fashion."[73]

USPS Provides Jobs

Some defend USPS by claiming it provides needed jobs. The American Postal Workers Union has circulated a petition focused on reducing USPS pension payments to the Treasury premised on saving "American jobs."[74] But bailing out USPS to save jobs is akin to John Maynard Keynes's quip that to create jobs the Treasury should bury bottles filled with money and people would go to work digging them up. In other words, the U.S. economy doesn't need these particular jobs in order to create jobs. Any jobs lost from creating a more efficient postal system would mean lower costs and prices and businesses and consumers would use these savings to buy other goods and services that provide value for them. Besides, if we really want jobs in the Postal Service, why don't we ban automatic mail sorting equipment and go to twice a day delivery. That would create postal jobs (but lead to fewer jobs in other areas as people would have to pay more for postal services).

CONCLUSION

Fixing the postal system is no easy task. Doing so will require tremendous political will on the part of all the players. As information technologies become an ever greater part of American life, the reason for the existence of USPS will gradually become less pressing. But the need for immediate change is pressing.

These proposals laid out here will change the Postal system to such an extent that it may no longer be recognizable. Competition may well force USPS out of every part of the postal system aside from the final mile monopoly. If that happens, so be it.

The important goal is improving overall efficiency and quality in the postal system (public and private) and improving service for customers, not to preserve USPS as we know it. As long as Americans want to move pieces of paper around the country in planes and trucks, a postal system is necessary; having USPS carry that paper every step of the way is not. Opening USPS to private competition outside last mile delivery is necessary to make the postal system better, and is therefore a step that should be taken.

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57. An analogous example is that of Fannie Mae and Freddie Mac, the government-sponsored enterprises that securetize mortgages under charter from Congress. Many critics of Fannie Mae and Freddie Mac contend that their profits were skewed because, even though the companies got no subsidies from the government, investors face little real risk due to the widely held belief that Congress will not let the companies fail. Which as we saw in 2009 was true. This perception, it is held, lowers the cost of capital for the companies and gives them a virtual monopoly on the secondary mortgage market.
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60. Though it is likely impossible to get an accurate estimate on the value of the indirect government subsidies and probably in excess of $1 billion per year.
61. On the other hand, privatization could vastly improve the financial picture if USPS were able to extract monopoly rents once free of the ratemaking process, or if they were able to break their unions and slash the wage premium that postal employees enjoy.
62. There is some argument over whether worksharing discounts are large enough to truly reflect the savings to USPS. Another objection to worksharing is that USPS fails to capture the savings due to

featherbedding—failing to eliminate the plants, equipment, and jobs that are unneeded because of the work being done outside the postal system.
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