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## **GOVERNMENT-IMPOSED ADVANTAGES AND BURDENS ON THE POSTAL SERVICE'S COMPETITIVE PRODUCTS: TWO WRONGS DO NOT MAKE A RIGHT**

Congress enacted the Postal Accountability and Enhancement Act (PAEA) after over a decade of Congressional deliberations on Postal Service reform. President Bush, whose Administration played an active and positive role in crafting the legislation, signed it into law on December 20, 2006.<sup>1</sup> One provision in PAEA directs the Federal Trade Commission (FTC) to prepare "a comprehensive report identifying Federal and State laws that apply differently to the United States Postal Service with respect to the competitive category of mail ... and to private companies providing similar products."<sup>2</sup>

In ordering this study, Congress properly recognized that the Postal Service offers several products outside the postal monopoly that compete with close private-sector alternatives. Compared to private-sector businesses, the government-owned Postal Service enjoys a wide array of government-based advantages and suffers from numerous government-imposed burdens in its competitive product operations. Congress perceptively asked the FTC to examine both the advantages and disadvantages; both sides have significant public policy implications. The legislation specifies that the FTC is to submit its report to the President, Congress, and the Postal Regulatory Commission by December 20, 2007.

The FTC has picked up on the challenge and issued a set of thoughtful and probing questions to help guide it in preparing the study. The quality of the questions is an encouraging sign that the FTC will produce a valuable study. Most of the issues have been examined in IRET's series of studies on the Postal Service, but in the past IRET has used separate papers to evaluate the Service's advantages and disadvantages. Given the FTC's thought-provoking questions, this would be a good time to update earlier IRET work and to examine the Postal Service's benefits and

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<sup>1</sup> H.R. 6407, which became P.L. 109-435, the Postal Accountability and Enhancement Act (PAEA). An earlier IRET study examined more fully the main elements of the new law. See Michael Schuyler, "Congress Delivers Postal Service Legislation," *IRET Congressional Advisory*, No. 216, January 8, 2007, available at <ftp://ftp.iret.org/pub/ADVS-216.PDF>.

<sup>2</sup> PAEA, sec. 703.

burdens in a single analysis. Hopefully, the analysis here will be useful to the FTC, the Postal Regulatory Commission, others in government, and the broader postal community.

IRET began its work on the U.S. Postal Service in the mid 1990s. Norman Ture, IRET's founder, believed that growth and prosperity are advanced by restricting government to a limited set of core functions. From this perspective he was concerned about the activities of government owned and sponsored businesses. The Postal Service stands out among government businesses because of its size – it employs about 30% of the federal government's civilian workforce. For many years – but fortunately much less so under the current Postmaster General – the Postal Service was also notable for aggressively trying to expand beyond its core mission.

### **A Key Point**

In the material that follows one of the most important thoughts to keep in mind is that *the Postal Service's special advantages and disadvantages in competitive markets both cause problems*. If one looks only at the Postal Service's bottom line, the advantages, which lower the government enterprise's costs, and the disadvantages, which raise its costs, have partially offsetting effects. It might almost seem as though the two sides partially counterbalance each other, as though two wrongs make a right.

From the perspective of the broader economy, however, the advantages and disadvantages rarely cancel out. In general, the advantages create distortions and the disadvantages cause additional distortions. In other words, the advantages do not correct the inefficiencies and higher costs caused by the burdens. Instead, the advantages generally take the form of transfers from others in the economy and act as indirect government subsidies that cover up some of the financial problems due to the Service's burdens.

For instance, many statutory requirements increase the Service's labor costs. They range from the highly specialized, such as being forced to comply with the Davis-Bacon Act on construction projects,<sup>3</sup> to the very broad, such as the requirement that the Service provide employees with several expensive fringe benefits. These statutory obligations apply to all Postal Service production; they do not distinguish between market-dominant and competitive product operations. The higher labor costs hurt the government enterprise's bottom line and reduce its ability to offer attractive combinations of price and service to customers. On the other hand, the Service saves money because of an assortment of exemptions and privileges that run the gamut from the small, such as not being bound by local zoning requirements on its construction projects, to the large, such as paying zero property tax on its huge property portfolio. These advantages apply to all the Service's activities, including its competitive product operations. In terms of the Service's finances, these burdens and benefits partially net out, but they are not offsets in other respects. The Service pays more than needed for labor, which is wasteful; it infringes on the authority of local governments to set zoning rules, which may result in inferior land use decisions; it weakens local

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<sup>3</sup> See Title 39, U.S.C., sec. 410(b)(4)(C).

tax bases, which hurts local government finances; and because of the combination of indirect government subsidies and higher labor costs, it may sometimes capture business that could be done more economically in the private sector.

The proposition articulated here does not apply only to the U.S. Postal Service. In a wide variety of circumstances, the distortions generated by special government burdens are compounded, not corrected, by special government favors. For example, at Amtrak, the government's inter-city passenger rail line, most long routes make terrible economic sense but are there for political reasons. The billions of dollars of federal subsidies that Amtrak has received and continues to obtain have kept the government enterprise in operation (barely) but are a burden on taxpayers and do not transform Amtrak's many wasteful and inefficient routes into efficient ones. As another example, consider European farmers, who must comply with many government requirements that increase their production costs but also receive generous agricultural subsidies. If the requirements do not pass a cost-benefit test they should not be there, regardless of the subsidies. And for efficiency in production in domestic and international markets, the subsidies should not be there, period. In the postal arena, the European Commission implicitly recognizes this principle when it objects to the blanket VAT exemption that the UK and German governments grant to their former monopoly posts. Although Royal Mail and Deutsche Post do have various government-imposed burdens, European Union Tax and Customs Commissioner Laszlo Kovacs correctly requests that the VAT be "applied in a way that minimises distortions of competition between former monopolies and market entrants to ensure that all operators enjoy the freedom to provide postal services across Europe."<sup>4</sup>

### **Organization of this Study**

Because the FTC's questions are thorough and systematic, they provide an attractive framework on which to organize this study. Each of the FTC's 11 questions will be briefly summarized, and then the issues it raises will be discussed.

### **The Postal Accountability and Enhancement Act's Two Definitions of Competitive Products**

Before considering the specific questions, it may be useful to mention that PAEA defines competitive products in two different ways. First, Congress lists which products are in the market-dominant basket and which are in the competitive basket.<sup>5</sup> Congress placed priority mail, expedited mail, bulk parcel post, bulk international mail, and mailgrams in the competitive

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<sup>4</sup> David Gow and Mark Milner, "EC Gets Tough On Royal Mail's VAT Exemption," *Guardian Unlimited*, July 24, 2007, accessed at <http://business.guardian.co.uk/print/0,,330261553-108725,00.html>. The European Commission does not object to subsidies or other payments to support the universal service obligation, which it regards as a public service. However, it insists that any subsidies be narrowly tailored to the government mission and not impede competition.

<sup>5</sup> For the market-dominant list, see PAEA, sec. 201, inserting Title 39, U.S.C., sec. 3621. For the competitive product list, see PAEA, sec. 202, inserting Title 39, U.S.C., sec. 3631.

category. In drawing up the lists, Congress was clearly influenced by market factors, but in some cases it may have classified products as "market-dominant" or "competitive" for non-market reasons.

When this study talks about competitive products, it is referring to the products now legally defined as "competitive", that is, those on the competitive products list in the legislation. While this conforms to current law, some earlier IRET studies had viewed more products as being in competitive markets, based on whether they were subject to direct competition from similar products in the private sector. For example, postal money orders face intense competition from other brands of money orders and from other very convenient means of transferring money. For that reason, they would seem to be a competitive product. Nevertheless, the law currently places postal money orders in the market-dominant category (as a type of special service).

Second, the legislation describes the market-dominant and competitive baskets in market-based terms:

"The market-dominant category of products shall consist of each product in the sale of which the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products. The competitive category of products shall consist of all other products."<sup>6</sup>

This second description does not affect the current composition of the baskets, but it may alter their future composition. PAEA authorizes the Postal Service's regulator, the Postal Regulatory Commission (PRC), to add, remove, or transfer products between the categories in the future if the PRC determines the changes would be appropriate.<sup>7</sup> In making its determinations, the law instructs the PRC to be guided by the second, market-based description of the categories, as well as certain other factors.<sup>8</sup> This is an intelligent delegation of authority by Congress, and one of many significant oversight responsibilities entrusted to the PRC. The PRC has the time, expertise, and partial insulation from immediate political pressures to recategorize products when necessary so that the market-dominant and competitive baskets correspond to reality in the marketplace.

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<sup>6</sup> PAEA, sec. 203, amending Title 39, U.S.C., sec. 3642(b)(1).

<sup>7</sup> PAEA, sec. 203, amending Title 39, U.S.C., sec. 3642.

<sup>8</sup> The law prohibits the PRC from moving products covered by the letter monopoly (defined by this section of PAEA as Title 18, U.S.C., sec. 1696) to the competitive category. Of course, products protected by a statutory monopoly should not be classified as competitive in any event.

**Competitive Products (as Defined by PAEA) as a Share of Postal Service Sales.**

The data the Postal Service provides on revenues from its various products is objective and generally noncontroversial. For that reason an appealing way to measure the relative size of the Service's competitive product operations is to compare those products' revenues with the Service's total revenues from all mail and special services.

The products that PAEA initially designates as competitive had revenues of about \$7.5 billion in 2006, which was 10%-11% of total revenues from all mail and special services.<sup>9</sup> The largest component by far, representing about two-thirds of competitive product revenues, is priority mail. Express mail, bulk parcel post, and bulk international mail are other significant components. In the past the Postal Service did not publicly release data separating parcel post and international mail into single-piece and bulk segments. To comply with the new law, the Service will undoubtedly soon begin providing that information. Until that happens, one cannot be sure of the exact revenues from the products on the competitive product list, but the above numbers are fairly close. PAEA also lists mailgrams as a competitive product, but mailgrams are no longer relevant because the Postal Service discontinued them effective February 28, 2006.

***Question 1 What statutory advantages does the Postal Service possess in its competitive product operations?***

The United States Postal Service enjoys many government-based powers and privileges not granted to private-sector businesses. Eleven legal requirements that apply to private-sector businesses but not the Postal Service are listed and briefly discussed here. The Postal Service's special treatment furnishes it with large, hidden, government-conferred benefits.<sup>10</sup>

In several cases, estimates are provided regarding the dollar value of the indirect government subsidies. Because many assumptions are needed to derive the estimates, the numbers indicate the approximate magnitude of some of the Postal Service's government-based advantages, but are not precise.

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<sup>9</sup> These numbers are based on an examination of U.S. Postal Service, "Cost And Revenue Analysis, Fiscal Year 2006," accessed at [http://www.usps.com/financials/\\_xls/fy06cra.xls](http://www.usps.com/financials/_xls/fy06cra.xls). The results are similar if one looks ahead to projected revenues for 2008. See Postal Regulatory Commission, "Opinion And Recommended Decision, Volume 2, R2006-1," Appendix G, Schedule 1, February 26, 2007, accessed at <http://www.prc.gov/docs/55/55901/VOL2Appendices.pdf>.

<sup>10</sup> The answer draws upon, and in some cases updates and extends, an earlier IRET study: Michael Schuyler, *The Anti-Competitive Edge: Government Subsidies To Government Businesses: Case Studies Of The Postal Service, TVA, And Amtrak* (Washington, DC: Institute For Research On The Economics Of Taxation, 1999).

PAEA narrowed or removed several of the Postal Service's government-based advantages. Two of the most important and positive changes are mentioned at the conclusion of the answer to Question 1.

Although the listing here of various legal requirements that apply to private-sector businesses but not the Postal Service is lengthy, it is by no means complete. Because the Postal Service is a federal entity, governments at all levels treat it very differently than they would a private-sector business, with the result that some of the Postal Service's advantages remain obscure.

For instance, the Postal Service's training facility in Potomac, Maryland, the Bolger Center, does double duty as a hospitality business (hotel, conference center, and food-and-drink establishment) that is open to the general public.<sup>11</sup> A complaint by a competing restaurateur that was picked up by the local press revealed that because the Bolger Center is a federal property, it is exempt from county alcoholic beverage licensing and control laws when it serves liquor on the premises, such as at the on-site Pony Express Bar and Grill. Although the Bolger Center's alcoholic beverage and other exemptions are a minor item relative to the Postal Service's budget (but a vexing concern for some small local competitors in the hospitality industry), they point out the often surprising range of the Service's government-based advantages.

Other examples abound. For instance, if any state were to pass do-not mail legislation (no state has passed such legislation but it has been proposed in a number), the Service's position within the federal government and its statutory authority might prevent the state law from being enforced.<sup>12</sup> As a totally different example, Wyoming grants on-the-job postal carriers a statutory exemption from the state's seat belt law (one of five exemptions in the act).<sup>13</sup>

One of the valuable services the FTC could perform with its study would be to fill in some of the blanks regarding the range of the Postal Service's government-bestowed privileges.

*Sales tax exemption.* State governments, and sometimes local governments, often require businesses to collect sales taxes on the products they sell. According to the Census Bureau, in a 12-month period covering parts of 2004 and 2005, state and local governments collected

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<sup>11</sup> The governmental powers and privileges that carry over to the Bolger Center's nonpostal business activities are detailed in Michael Schuyler, "The Postal Service's Hotel Wants Your Business," *IRET Congressional Advisory*, No. 202, April 18, 2006, available at <ftp://ftp.iret.org/pub/ADVS-202.PDF>.

<sup>12</sup> If a state were to enact such legislation and the matter went to court, it would probably reach the Supreme Court, which has often, although not always, shown deference to the Postal Service. See the following letter from an attorney representing a trade association to the Postal Service's General Counsel: Ian D. Volner, Letter to Mary Ann Gibbons, Vice President and General Counsel, U.S. Postal Service, February 23, 2007, accessed at <http://www.postcom.org/public/2007/donotmail.pdf>.

<sup>13</sup> Wyoming Statutes, Title 31, Chapter 5, Sec. 1402(b)(3), accessed at <http://legisweb.state.wy.us/statutes/titles/Title31/T31CH5AR14.htm>. This is probably a sensible exemption given the nature of the job, but it is an exception not available to other businesses.

\$383 billion in general sales and gross receipts taxes (\$311 billion at the state level and \$72 billion at the local level).<sup>14</sup> General sales and gross receipts taxes are a major revenue raiser at those levels of government. The Postal Service, however, is a federal entity and, as such, it does not have to charge any state or local sales taxes on its postage sales or pay any gross receipts taxes. This is a significant federally conferred benefit.

In 2006, the unweighted average sales tax rate at the state level was 4.83%.<sup>15</sup> If each state's sales tax rate is weighted by that state's share of gross domestic product (GDP), the weighted average sales tax rate at the state level was 5.37%.<sup>16</sup> These averages do not include the general sales taxes that local governments often impose. A reasonable estimate is that local sales taxes raise the weighted average sales tax rate by 1.2 percentage points, to 6.57%.<sup>17</sup>

In 2006, the Service had total sales of \$72.6 billion.<sup>18</sup> Suppose a normal private-sector business sold goods with that value. Also, because not all sales to all customers are ordinarily subject to sales tax, suppose the normal business collected sales taxes on only two thirds of its sales.<sup>19</sup> A rough estimate is that its general sales taxes would have been \$2.6 billion at the state level and \$3.2 billion at the state and local levels. The sales tax exemption is clearly a valuable

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<sup>14</sup> U.S. Census Bureau, Governments Division, "State and Local Government Finances by Level of Government and by State: 2004-05," last revised May 14, 2007, accessed at [http://www.census.gov/govs/estimate/0500ussl\\_1.html](http://www.census.gov/govs/estimate/0500ussl_1.html).

<sup>15</sup> See Tax Foundation, "State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State, as of December 31, 2006," Accessed at <http://www.taxfoundation.org/files/variousstaterates-20070201.xls>. The Tax Foundation's data set includes the 50 states plus the District of Columbia.

<sup>16</sup> The author calculated the weighted average rate using data from U.S. Bureau of Economic Analysis, "Gross Domestic Product by State, 2005" accessed at <http://www.bea.gov/regional/gsp>; and Tax Foundation, "State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State," *op. cit.* State GDP is not a perfect proxy for state sales, but it is a reasonably good proxy. Basing the weights on 2005 state GDPs should produce almost the same results as if 2006 data were used. (The Bureau of Economic Analysis has not yet released 2006 data.) The weighted average state sales tax rate is higher than the unweighted average because some large states have relatively high sales tax rates.

<sup>17</sup> The Census Bureau provides data, for each state, on total general sales tax collections, collections at the state level, and collections at the local level. (U.S. Census Bureau, "State and Local Government Finances by Level of Government and by State: 2004-05," *op. cit.*) The author used that information to gross up, for each state, from the general sales tax rate at the state level to the rate at the state plus local levels.

<sup>18</sup> U.S. Postal Service, "Cost And Revenue Analysis, Fiscal Year 2006," *op. cit.* It should be noted that the Postal Service data is for fiscal year 2006 while the tax rate estimates are for calendar year 2006. However, that difference should have only a minor effect on the revenue estimates here.

<sup>19</sup> A portion of the Service's competitive product sales are business-to-business sales. Under a true retail sales tax, these transactions would not be taxed. State and local sales taxes, however, are rarely pure retail sales taxes. They often tax a significant share of business-to-business sales.

indirect government subsidy to the Postal Service. If one considers only the Postal Service's competitive products, sales and sales taxes would be about 10%-11% of the above numbers.

*Property tax exemptions.* The Postal Service is not liable for local property taxes on any of the real property it owns. (The exemption does not extend to real properties leased from private-sector landlords. The private-sector landlords pay property taxes, and they presumably pass along the taxes in the rents they charge.) The Postal Service is also exempt from local personal property taxes on its equipment and other non-real-property physical assets.

Private-sector companies sometimes obtain lower property taxes in return for locating, expanding, or remaining in a certain state or locality. Such breaks are usually temporary and for specific properties. In contrast, the Postal Service's tax break is for all its real estate, structures, and equipment, all the time.

The Service's property holdings are enormous. In 2006, it owned 8,437 facilities and 937 million square feet of land.<sup>20</sup> Valuing its real property and equipment at original cost less depreciation and amortization, it reported they had a value of \$23.1 billion in 2006.<sup>21</sup> Their market value would undoubtedly be considerably higher.

Estimating the Service's savings due to its exemptions from real and personal property taxes is challenging because property taxes are usually assessed on assets' market values, which the Service does not report, and because nominal tax rates and assessment levels vary greatly from one locality to the next. In a survey of 51 cities in 2005, the District of Columbia found that the effective tax rate on residential real property (i.e., the nominal rate times the assessment level) varied from 0.38% to 3.21%, with an unweighted average of 1.64%.<sup>22</sup> The survey, however, did not look at tax rates on commercial real property and commercial personal property.

To provide a rough estimate of the value to the Postal Service of its real and personal property tax exemptions, the approach used here begins by looking at aggregate national data on property tax collections and asset values. The U.S. Census Bureau reports that in a 12 month period covering parts of 2004-2005, state and local governments collected \$336 billion in property taxes (with \$324 billion of that at the local level).<sup>23</sup> The U.S. Bureau of Economic Analysis estimates

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<sup>20</sup> U.S. Postal Service, *Comprehensive Statement on Postal Operations, 2006, 2007*, p. 25, accessed at <http://www.usps.com/strategicplanning/cs06/cs2006.pdf>.

<sup>21</sup> U.S. Postal Service, *Annual Report, 2006*, p. 44, accessed at [http://www.usps.com/financials/\\_pdf/anrpt2006\\_final.pdf](http://www.usps.com/financials/_pdf/anrpt2006_final.pdf).

<sup>22</sup> Government of the District of Columbia, "Tax Rates and Tax Burdens in the District of Columbia - A Nationwide Comparison, 2005," August 2006, p. 17, accessed at [http://cfo.dc.gov/cfo/frames.asp?doc=/cfo/lib/cfo/services/studies/Tax\\_Burden\\_05NATION.pdf](http://cfo.dc.gov/cfo/frames.asp?doc=/cfo/lib/cfo/services/studies/Tax_Burden_05NATION.pdf).

<sup>23</sup> U.S. Census Bureau, "State and Local Government Finances by Level of Government and by State: 2004-05," *op. cit.*



that in 2005, the current-cost value of private-sector fixed assets was \$29,344 billion.<sup>24</sup> These numbers can be used to calculate that the average effective state and local tax rate on real and personal property held in the private sector is about 1.15%.<sup>25</sup> If one knew the market value of the Postal Service's assets, one could multiply that amount by 1.15% to estimate how much the Service would have paid in property taxes if not for its exemptions. However, as mentioned above, the Service only reports its assets at historic cost. Multiplying the historic cost of the Service's assets, less depreciation and amortization, by the estimated property tax rate produces an estimated property tax saving of \$265 million yearly for the Service.

The estimate would be considerably higher if data on the market value of the Service's assets were available because market values typically exceed historic costs. In a rare case in which the Postal Service provided a comparison of book and market values, it reported that the market prices it received on the excess real properties it sold in 1999 were seven times the properties' book values.<sup>26</sup> If market values are even three times historic costs on average, the estimate for this indirect government subsidy would rise to nearly \$800 million annually.

To estimate how much the property tax exemptions are worth to the Postal Service's competitive operations, one could undertake a comprehensive review of the agency's assets to allocate them to market-dominant or competitive operations. In its accounting, the Service will attempt to make such an allocation. A simpler method is to assume that assets are used in market-dominant and competitive operations in proportion to the Service's revenues in the two areas.

*Income tax exemptions.* The Postal Service does not pay federal, state, or local income taxes. Because the Service has reported only a small net income over the period 1971-2006 and lost money in the majority of those years, its income tax liabilities would not have been large if it had been taxable. A definite advantage, though, is that the Service avoids income tax compliance costs. It does not have to prepare income tax returns, assemble extra records for income tax purposes, worry about income tax audits, or fight the government in court if its income tax returns are challenged. The compliance costs would be several million dollars yearly, even if the Service only had to pay income taxes on its competitive product operations. (Income tax compliance costs are discussed more fully in the Question 9.) If the Service became involved in a tax dispute following an audit that led to major litigation, the cost could be several times higher.

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<sup>24</sup> U.S. Bureau of Economic Analysis, National Income and Product Accounts, "Current-Cost Net Stock of Fixed Assets and Consumer Durable Goods," revised August 15, 2006, accessed from <http://www.bea.gov/national/FA2004/SelectTable.asp>. Private-sector fixed assets consist of nonresidential structures, nonresidential equipment and software, and residential assets.

<sup>25</sup> The estimate of the effective tax rate would be more precise if it excluded residential property and just pertained to commercial property, but the BEA data set on property tax collections is not sufficiently disaggregated to permit that.

<sup>26</sup> This instance is detailed in Michael Schuyler, "The Postal Service's Surplus Real Estate," *IRET Congressional Advisory*, No. 155, June 24, 2003, available at <ftp://ftp.iret.org/pub/ADVS-155.PDF>.

The PAEA does create a federal "assumed income tax".<sup>27</sup> The Service is to compute what the corporate income tax would be on a normal private-sector corporation with the same income as the Service's competitive product operations. Unlike a real income tax, however, the Postal Service will not have to send any money to the IRS. Instead, the "tax" will be an internal Postal Service transfer, from the Competitive Products Fund to the Postal Service Fund. The assumed tax will have no effect on the Service's continued exemption from state and local income taxes.

The assumed income tax is a clever device in several respects. It will provide experience regarding how to administer an income tax on the Postal Service's competitive products. It will force the Service's competitive product operations to show on their books a cost equal to what the federal corporate income tax would be. That cost entry will partially remove one of the Service's many government-based advantages from its competitive operations. The assumed income tax passes political muster while a real income tax probably would not at this time. A weakness, though, is that because the "assumed tax" is really only an internal transfer, the Service may shrug it off as irrelevant, unless it reduces the amount in the Competitive Products Fund below what the Service wants to spend on competitive product operations and the Service cannot devise a way to get the money from some offsetting transfer elsewhere. Ordinary firms and households would be delighted if they could pay their taxes to themselves.

*A low-cost alternative to the unemployment tax.* Another tax subsidy involves unemployment compensation taxes. As is usual in the government sector, the Postal Service does not pay unemployment compensation taxes on its employees' wages but only reimburses the Federal Unemployment Trust Fund when former employees draw benefits.<sup>28</sup> The Department of Labor bills the Service quarterly, and its reimbursements were \$41.5 million in 2005 and \$81.6 million in 2006.<sup>29</sup>

Unemployment taxes usually exceed benefit payouts by a wide margin in the private sector. The Federal Unemployment Trust Fund had a balance of \$66.6 billion at the end of 2006, and ran a surplus, excluding interest earnings, of \$9.1 billion for the year<sup>30</sup>. The massive fund balance indicates that unemployment taxes on private-sector companies have long been higher than needed to cover benefits. For 2006 alone, a comparison of that year's \$9.1 billion dollar surplus with the

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<sup>27</sup> PAEA, sec. 402, amending Title 39, U.S.C., sec. 3634. Notice that this "tax" goes in the Postal Service portion of the U.S. Code, not the income tax portion.

<sup>28</sup> See Title 5, U.S. Code, Chapter 85.

<sup>29</sup> U.S. Postal Service, "Cost Segments And Components, Fiscal Year 2005 – PRC Version," p. C-22, accessed at <http://www.prc.gov/docs/48/48054/csc-fy2005.pdf>; and U.S. Postal Service, "Cost Segments And Components, Fiscal Year 2006," p. C-23, accessed at [http://www.usps.com/financials/\\_pdf/fy06segcomp.pdf](http://www.usps.com/financials/_pdf/fy06segcomp.pdf).

<sup>30</sup> U.S. Office Of Management And Budget, *Budget Of The United States Government, Fiscal Year 2008, Analytical Perspectives*, January 2007, p. 351.

number of private-sector workers indicates that the average overcharge per worker was about \$80.<sup>31</sup> Because the Postal Service and other government employers only have to repay actual expenses, they receive a better deal than private-sector businesses.

To obtain a rough idea of the Postal Service's saving due to this special treatment, suppose it had been forced to pay the unemployment tax and been overcharged the same amount per worker as the average private-sector employer. Based on these assumptions and the size of its workforce, the Postal Service saved approximately \$60 million in 2006 by repaying benefits rather than paying the tax. Although this is a rough estimate (the Service does better in years when actual reimbursements are low than when they are high, and it might not suffer the average overcharge if it were treated like a private-sector business), the results suggest that the Service's special, government-based arrangement saves it millions of dollars yearly.

*State motor fuel tax exemption.* The Postal Service does pay the federal motor fuel excise tax. That tax is 18.4 cents per gallon for gasoline and 24.4 cents per gallon for diesel fuel.<sup>32</sup> However, many states exempt the federal government from their motor fuel taxes, and the Postal Service is a federal government entity. The unweighted average rate for state motor fuel taxes is 21.3 cents per gallon for gasoline and 21.88 cents per gallon for diesel fuel. (Several states tack on added taxes that boost the effective rates, but those add-on taxes are not considered here.)

Little information is available on the extent to which the Postal Service uses its federal status to avoid state motor fuel taxes. The agency acknowledges that it may be exempt in some cases, but it has not volunteered hard numbers. To begin filling in the information gap, this study's author contacted a number of state tax departments directly and asked them whether the Postal Service is eligible to be exempted from their state motor fuel tax, either at the pump or through a rebate. Approximately half the states were contacted in May and June 2007 by telephone or e-mail, and 19 responded.

Two states answered that the Postal Service is not exempt from their state motor fuel tax (Kentucky and Oregon). One said that federal agencies are exempt from a portion of the tax (Mississippi). One mentioned a federal government exemption but did not explicitly say whether it applies to the Postal Service (Pennsylvania). The other 15 replied that the Postal Service is

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<sup>31</sup> Private sector employment averaged 114.2 million in 2006 (U.S. Bureau of Labor Statistics, Total Private Employment, Employment, Hours, and Earnings from the Current Employment Statistics survey (National), accessed from <http://www.bls.gov/ces/home.htm>.) Not all of these workers were in covered employment subject to unemployment taxes, which means that the number in the text actually understates the average overcharge per covered private-sector worker.

<sup>32</sup> The data in this paragraph is drawn from Energy Information Administration, *Petroleum Marketing Monthly*, June 2007, p. 154, accessed at [http://www.eia.doe.gov/pub/oil\\_gas/petroleum/data\\_publications/petroleum\\_marketing\\_monthly/current/pdf/enote.pdf](http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_marketing_monthly/current/pdf/enote.pdf).

exempt, either at the pump or through a rebate.<sup>33</sup> Several noted that contractors working for the Postal Service are not exempt; the tax exemption is tied to federally owned vehicles.

Based on data the Service provides on the number of miles its vehicles traveled and their miles per gallon, its vehicle fleet consumed 121 million gallons of fuel in 2006.<sup>34</sup> (This excludes the fuel that contractors used in non-Postal-Service vehicles.) With that much fuel consumption, the Postal Service may be saving several million dollars yearly in state motor fuel taxes. Suppose, for instance, that the Service avoids, on average, 50% of the state motor fuel tax. Its saving would be about \$13 million yearly.

The state responses do not establish whether the Postal Service fully claims available state motor fuel tax exemptions, or whether some states impose additional requirements that have the effect of disqualifying the Service. The Postal Service, though, should be able to furnish this information if asked by its regulator or by a government agency like the GAO or the FTC. (If the Postal Service says it does not collect nationwide data on this item, an alternative approach would be to select several local areas and ask the Service if it is exempt, at the pump or via rebates, from state fuel taxes and perhaps other road use taxes in those areas.)

*Limitations on suits against the Postal Service for negligent or wrongful acts or omissions by its employees.* The Federal Tort Claims Act (FTCA) waives the federal government's sovereign immunity in cases of injury allegedly caused by "by the negligent or wrongful act or omission" of its employees.<sup>35</sup> The law, however, contains numerous restrictions and exclusions. One exclusion especially germane to the Postal Service is that the agency cannot be sued for "[a]ny claim arising out of the loss, miscarriage, or negligent transmission of letters or postal matter."<sup>36</sup> Further, when suits are allowed to go forward, they are heard in federal court by a federal judge sitting without a jury, not in a state court. These special rules apply to the Service's competitive products, as well as its market-dominant ones.

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<sup>33</sup> The states that responded were Alabama, Connecticut, Georgia, Illinois, Indiana, Kansas, Kentucky, Maine, Minnesota, Mississippi, Nebraska, New Jersey, North Dakota, Ohio, Oregon, Pennsylvania, South Dakota, Wisconsin, and Wyoming. Five cited state statutes in their replies: Kansas S.A. 79-3408, Nebraska Revised Statute Section 66-489(6), New Jersey S.A. 54:39-65, Ohio Code 5735.05(a)(5), Wisconsin Statute 78.01, and Wyoming statutes 39-17-105, 39-17-205, and 39-17-209.

<sup>34</sup> U.S. Postal Service, *Comprehensive Statement on Postal Operations, 2006, op. cit.*, p. 24.

<sup>35</sup> Title 28, U.S.C., sec. 1346(b).

<sup>36</sup> Title 28, U.S.C., sec. 2680(b). What this means, in general terms, is that the Postal Service cannot be sued for losing or damaging mail, delivering it late, or delivering it to the wrong person. It can be sued under the FTCA for such things as traffic accidents allegedly caused by postal employees or, in a recently decided Supreme Court case, injuries caused by tripping over mail that a postal carrier allegedly placed improperly on a porch (*Dolan v. United States Postal Service et al.*, 546 U.S. 481 (2006)).

Being able to keep suits out of state courts is generally regarded as a significant advantage for the Postal Service. The other restrictions also reduce its legal risks in tort cases, compared to the risks of private-sector businesses. Although it is difficult to place a monetary value on these special privileges, they certainly benefit the Postal Service relative to private-sector businesses.

*Zoning laws.* "[Z]oning laws, land use laws, and applicable [construction-related] environmental laws of a State or subdivision" are voluntary for the Postal Service.<sup>37</sup> When the Service constructs or alters a building, the law requires it to consult with local officials, provide the local officials with information, listen to their recommendations, and "give due consideration to any such recommendations." The Service must also gather community input. In other words, the Service is to make a good faith effort to satisfy local concerns. However, if the Service concludes that local demands are not reasonable or feasible, it may go ahead without local permission. Also, the Service and its contractors need not pay state and local government fees for construction-related reviews, permits, and inspections. When private-sector businesses construct or alter buildings, the story is completely different. Zoning, land use, and construction-related environmental laws and fees are mandatory, not voluntary.

Because the Postal Service has a portfolio of thousands of properties, this exemption definitely has value, although it is difficult to estimate the dollar amount. The power to treat zoning laws as optional may perhaps be most welcome to the Service when it believes that a local government is being difficult.

*Eminent domain.* Private-sector businesses cannot force other parties to sell them property. The Postal Service can. The Service possesses the governmental power to acquire real property through the use of eminent domain.<sup>38</sup> The Service states that it exercises this power "[o]nly under unusual and compelling circumstances, and on a case-by-case basis..."<sup>39</sup> Nevertheless, the knowledge that the Service can invoke eminent domain undoubtedly gives it extra leverage in some negotiations. While this power clearly has monetary value, much additional information would be needed to estimate its worth in dollars.

*Parking Tickets.* Because the Postal Service is a federal government entity and is empowered by federal law to carry out its task, it is generally immune from having its vehicles ticketed for local parking violations.<sup>40</sup> In contrast, private individuals and businesses must obey parking regulations

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<sup>37</sup> PAEA, Section 404(a), amending Title 39, U.S.C., sec. 409(f).

<sup>38</sup> Title 39, U.S.C., sec. 401(9).

<sup>39</sup> 39CFR777.31(7-1-06 edition).

<sup>40</sup> In *United States v. City of Pittsburgh* (661 F.2d 783 (9th Cir. 1981)), a federal appeals court ruled that federal law preempted a local trespassing ordinance that would have prohibited postal carriers from cutting across lawns. The court's ruling suggests that if a municipality did ticket postal vehicles for illegal parking while on official business, the courts would void the tickets.

or risk tickets. This immunity benefits the Service in time (its drivers do not have to search as long for parking spaces while on official business) and in cash (the Service does not have the expense of paying parking tickets).

For the agency's competitors in markets like package delivery and urgent document delivery, the parking fines quickly add up. This cost of doing business is especially acute in cities where parking spaces are scarce or ticket writers aggressive, such as New York, San Francisco, Boston, and Washington. In New York City alone, the Service's major rivals each pay several million dollars yearly for parking tickets.<sup>41</sup> In San Francisco, each has annual parking-ticket bills of several hundred thousand dollars.<sup>42</sup> Although national totals by company are apparently not compiled, the small amount of city data available suggests that parking tickets cost the Service's competitive-product rivals tens of millions of dollars annually. A plausible guess is that the Postal Service also saves tens of millions of dollars yearly on competitive-product deliveries because its vehicles do not receive parking tickets. The Service's time savings are in addition to this.

*No state motor vehicle department licensing and registration fees.* As part of the federal government, the Postal Service does not have to register its vehicles with state motor vehicle departments or pay registration and licensing fees. When one considers that state and local governments charged \$20 billion for motor vehicle licenses in a 12 month period covering parts of 2004 and 2005<sup>43</sup> and that the Postal Service's fleet of 216,000 vehicles<sup>44</sup> is one of the largest in the world, it is obvious that this exemption lowered the agency's costs. Private-sector businesses, of course, do not enjoy this exemption.

Just as an illustration, suppose that the normal licensing charge per commercial vehicle is \$100. At that rate, the licensing cost for the Service's fleet would be \$21.6 million, if not for the exemption. Competitive products account for 10%-11% of the Service's revenues. If the savings are apportioned between market-dominant and competitive products in proportion to their revenues, the agency's competitive product operations save over \$2 million annually because the agency's vehicles do not require state motor vehicle licenses.

*The Postal Service can travel on some highways from which commercial vehicles are normally prohibited.* Some roads, such as the George Washington Memorial Parkway outside Washington, are open to Postal Service vehicles, including large Postal Service trucks, but closed to commercial

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<sup>41</sup> See Associated Press, "Parking Tickets Make Cost Of Doing Business Steep In NYC," August 31, 2006, accessed at [http://abclocal.go.com/wabc/story?section=business\\_week&id=4514997&ft=print](http://abclocal.go.com/wabc/story?section=business_week&id=4514997&ft=print).

<sup>42</sup> See Rachel Gordon, "Parking Tickets By The Truckload; 18 S.F. Businesses Rack Up Thousands Of Citations, Pay City On Monthly Plan," *San Francisco Chronicle*, p. A-1, February 24, 2007, accessed at <http://sfgate.com/cgi-bin/article.cgi?f=/chronicle/archive/2007/02/24/MNGMPOAK521.DTL>.

<sup>43</sup> U.S. Census Bureau, Governments Division, "State and Local Government Finances by Level of Government and by State: 2004-05," *op. cit.*

<sup>44</sup> U.S. Postal Service, *Comprehensive Statement on Postal Operations, 2006, op. cit.*, p. 24.

vehicles, including those of its competitive-market rivals. This is a localized advantage for the Service, but it is a real time saver on a few routes. It is another reminder that the Postal Service retains many government-conferred privileges even when it steps outside its core mission and sells competitive products.

*Two governmental privileges that the Postal Accountability and Enhancement Act (PAEA) restricts.* In 2004, the Supreme Court ruled that because the Postal Service "is part of the Government of the United States" and because there was not (at the time) "an express statement from Congress that the Postal Service can be sued for antitrust violations", it was "not controlled by the antitrust laws."<sup>45</sup> PAEA explicitly strips the Postal Service of antitrust immunity for products outside the postal monopoly.<sup>46</sup> This is a salutary change because it means that if the Postal Service should engage in anti-competitive behavior in its competitive product operations in the future, it would have to worry about the antitrust-law consequences.

In one respect, though, the antitrust laws do not apply as forcefully to the Postal Service's competitive product operations as to private-sector companies:

"No damages, interest on damages, costs or attorney's fees may be recovered, and no criminal liability may be imposed, under the antitrust laws (as so defined) from any officer or employee of the Postal Service, or other Federal agency acting on behalf of or in concert with the Postal Service, acting in an official capacity."<sup>47</sup>

Officers of private-sector businesses do not possess that immunity.

Another change made by PAEA concerns Securities and Exchange Commission (SEC) financial reporting requirements. Previously, SEC financial reporting requirements did not apply to the Postal Service. The Service expressed matters this way in its most recent *Annual Report*: "We are not subject to regulation by the Securities and Exchange Commission (SEC), nor are we required to produce, publish or file financial reports that comply with the SEC's rules and regulations on financial reporting."<sup>48</sup> The Service did volunteer that it would conform to SEC reporting requirements when it believed doing so would be feasible and useful. "[W]e are guided by SEC reporting requirements to the extent deemed practical for a non-publicly traded, government-owned entity with a break-even mandate."<sup>49</sup>

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<sup>45</sup> United States Postal Service v. Flamingo Industries (USA) Ltd. et al., Supreme Court of the United States, Case No. 02-1290, decided February 25, 2004, accessed at <http://supremecourtus.gov/opinions/03pdf/02-1290.pdf>.

<sup>46</sup> PAEA, sec. 404.

<sup>47</sup> Section 404(a) of PAEA, amending Title 39, U.S.C., sec. 409(e)(2).

<sup>48</sup> U.S. Postal Service, *Annual Report, 2006, op. cit.*, p. 19.

<sup>49</sup> *Ibid.*

In the future, the Postal Service will not longer be able to treat SEC financial disclosure rules as voluntary guideposts. PAEA directs the Service to begin submitting reports to the PRC that comply with various SEC financial reporting requirements.<sup>50</sup> Whereas the goal of SEC requirements as they apply to private-sector companies is to protect investors in the companies, the aim with the Postal Service is to increase financial transparency to protect mail users and taxpayers.<sup>51</sup> One of the most criticized features of the Service's accounting is that the Service claims about 40% of its costs are overhead costs unrelated to any specific products. The concern is that many of those costs should properly be associated with various products but aren't.

Unlike private-sector companies covered by SEC requirements, however, the Postal Service does not have to register with the SEC and is not subject to SEC enforcement actions. Enforcing the financial reporting requirements will be up to the Service's regulator, the PRC.

Beyond the specifics of these two changes, they provide a reminder that it is often administratively feasible to narrow the Postal Service's special privileges in its competitive product operations or throughout the organization, provided the political decision is made to do so.

***Question 2 Do the Postal Service's competitive product operations obtain benefits from the Service's statutory monopolies on letter delivery and mailbox access?***

The federal government has granted the Postal Service statutory monopolies on letter delivery and mailbox access. The monopolies are specified in Title 18 of the United States Code, which covers federal crimes and criminal procedures. The monopoly on the carriage of letters and packets is contained in Title 18, U.S.C., sec. 1692-1699. The mailbox monopoly, which was added in 1934, is found in Title 18, U.S.C., sec. 1725. Violating one or both monopolies is a federal crime. Technically, the monopolies do not bar third parties from carrying mail or depositing material in mailboxes, but from doing so without paying postage. Title 39 U.S.C., sec. 601(a) waives the letter monopoly and allows the private carriage of letters if full postage is affixed. Similarly, Title 18, U.S.C., sec. 1725 allows third parties to place material in mailboxes if full postage is paid.

The letter monopoly, in combination with the universal service obligation, means that only the U.S. Postal Service has mail delivery routes that go by most addresses in the nation on an almost daily basis. The effect of the mailbox monopoly is that, as a practical matter, only the Postal Service can use mailboxes when making deliveries. The monopolies have enabled the Postal Service to become and remain a huge organization with massive revenues. Even in the Internet age, non-urgent, hard-copy letters are an extremely useful means of conveying information and

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<sup>50</sup> PAEA, sec. 204, inserting Title 39, U.S.C., sec. 3654.

<sup>51</sup> Some observers have concluded that various SEC requirements, particularly those associated with the Sarbanes-Oxley Act of 2002, go too far. Especially controversial is section 404 of Sarbanes-Oxley, which mandates burdensome internal controls, and which will apply to the Postal Service starting in 2010. If the SEC requirements do overreach, the correct solution would be to modify them for everyone, based on a comparison of each requirement's costs and benefits.



documents. In 2006, the Service had nearly 800,000 employees, revenues of \$72.8 billion, and delivered 213.1 billion pieces of mail.<sup>52</sup> If it were a private-sector company, it would be one of the largest in the nation or the world.

The monopolies provide the Postal Service with several benefits when it offers competitive products. In one case mentioned below, the monopolies generate economies of scope that allow the Service to more efficiently provide a competitive product. Often, however, the monopoly-derived advantages that spill over into competitive markets fail to promote, or actually conflict with, economic efficiency in the provision of competitive products.

The marketplace offers a practical test of whether the Service's dual monopolies produce frequent, powerful economies of scope. If economies of scope are large, the Postal Service should enjoy cost savings that often allow it to dominate the competitive markets it enters. Instead, the historical pattern is that the Service has difficulty maintaining market share when it faces direct competition. This pattern indicates that economies of scope are usually quite limited (or that the Service has operational problems that reduce its competitiveness despite economies of scope.) Now several monopoly-derived advantages will be considered.

One monopoly-derived advantage is that the Service has an enormous cash flow. That cash gives it a ready means to finance extensive competitive-market forays, unless the Service is blocked by statutory restrictions on its non-core operations or by accounting rules enforced by its regulator. As an example of where this and other government-derived favors may lead in the absence of political and accounting restrictions, consider Japan. Japan Post used its postal monopoly and other government-granted favors to move into banking and to become the largest bank in the world, as measured by deposits. Recently, Japan began the process of privatizing Japan Post and separating the pieces, with one of the driving forces being concerns that the postal bank was promoting waste and corruption and interfering with the efficient allocation of capital.<sup>53</sup> Japan Post's cautionary tale highlights the fact that monopoly-derived financing often conflicts with economic efficiency.

Another monopoly-related advantage that spills over into competitive markets is the power of the mailbox monopoly to reduce the attractiveness of private companies' competitive products. The Service demonstrated this power in the 1990s when it put out of business several firms trying to compete with it in distributing advertising flyers and periodicals. (The flyers and periodicals were not covered by the statutory monopoly against the private carriage of letters and packets.) Because the private firms could not legally place their material in mailboxes (unless they affixed postage,

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<sup>52</sup> U.S. Postal Service, *Annual Report, 2006, op. cit.*, pp. 56, 58, and 60.

<sup>53</sup> For a short overview of the planned reform, see Anthony Faiola, "Japan Approves Postal Privatization; Vote Delivers Big Victory to Koizumi," *Washington Post*, October 15, 2005, p. A10, accessed at [http://www.washingtonpost.com/wp-dyn/content/article/2005/10/14/AR2005101402163\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2005/10/14/AR2005101402163_pf.html). Privatizing a government enterprise so that it does not retain anti-competitive advantages can be tricky. For concerns by U.S. insurance companies in the case of Japan Post, see "Japan Post Perks Irk U.S. Insurers," *The Japan Times* (English), Jan. 31, 2007, accessed at <http://search.japantimes.co.jp/print/nb20070131a8.html>.

which would have destroyed their business models), they generally left it at doorways in plastic bags. Recipients often found this arrangement inferior to the mailbox, and the Service's main competitors soon went out of business. As a result, some advertising flyers and periodicals that could be delivered by private-sector businesses are instead delivered by the Postal Service, in the market-dominant product lines of standard mail and periodicals. The Postmaster General at the time, Marvin Runyon, boasted, "Remember the alternate delivery company called Publishers Express... We ran them out of business... I can't say that I am sorry to see them go..."<sup>54</sup> The same statutory restriction applies to packages.

A potentially more positive monopoly-derived benefit is associated with the Service's network of post offices. Post offices mainly serve monopoly-market customers, but can function as drop-off/contact points for walk-in customers of competitive products. The existing network of post offices lets the Service avoid the expense of setting up a network of brick-and-mortar contact points for competitive product customers from scratch. Although this is certainly an economy of scope, it generally does not give the Postal Service an efficiency edge over private-sector businesses. Many private-sector businesses, such as package-delivery companies, financial institutions, food stores, and drug stores, also have extensive networks of drop-off/contact points, which provide them with economies of scope, too. Moreover, the Postal Service has difficulty using its brick-and-mortar network to advantage in competitive markets because of its high labor costs.

One case where post offices could be put to good use outside the mail monopoly should be mentioned, although it does not involve competitive products. Suppose another government agency wants more physical locations at which people can pick up or drop off forms or documents, either for the agency's own needs or for the convenience of the general public. Provided that the forms and documents are fairly straightforward, this is something that post offices, which are already in place and are staffed by federal employees, could readily handle. For efficiency, the Postal Service should charge the other agency for the Service's extra costs, and the sharing arrangement should only go forward in instances where the Service's cost-based charge is less than the other agency's savings on rent, labor, and other expenses. It would be worthwhile for a government fact-finding body like the Government Accountability Office (GAO) to examine whether post office counters can efficiently be used as a federal government resource to improve public access to other government agencies.

Postal officials in this country and abroad frequently assume that a postal monopoly creates large economies of scope in the "final mile". The notion is that because mail carriers have routes that take them by most addresses on most days, they could drop off or pick up other products with little additional effort or cost.

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<sup>54</sup> Marvin Runyon, "Remarks by Postmaster General Marvin Runyon before the NAPUS Leadership Conference," Washington, D.C., February 20, 1996, originally accessed on the Internet at <http://www.usps.gov/news/speeches/96/022096sp.htm>. Also see Michael Schuyler, "Empire Building At The Postal Service," *IRET Policy Bulletin*, No. 87, May 19, 2003, footnote 13, accessed at <ftp://ftp.iret.org/pub/BLTN-87.PDF>.

The Service and its competitors in the package delivery business are currently offering some value-priced services that provide a concrete example of this. A private-sector company carries a package most of the way to the destination, and it then turns the package over to the Postal Service for the "final mile". Current law permits this interconnection between private-sector suppliers of competitive products and the Postal Service. Because both sides voluntarily offer these products, the sharing arrangements are presumably mutually profitable. And in order to be mutually profitable, the Postal Service must be the lower cost provider on the trip to the mailbox, which means the arrangements are also economically efficient and benefit the economy.<sup>55</sup>

Such cases, however, are not the general rule for most products. Because of the specialized nature of postal delivery, the reality seems to be that few economies of scope are available unless products are shaped like letters, can be handled like letters, and can be placed in mailboxes like letters. For example, if a mail carrier needs to make a special, extra trip to deliver an express mail envelope, the potential economy from being able to piggyback on the normal mail delivery is entirely lost. (The fact that the Postal Service has been able to retain only a small share of urgent-mail deliveries is market-based evidence that its economies of scope in that competitive product line are relatively weak.) As another example, postal vehicles and carriers' mail bags are designed with letter delivery in mind; they are not optimally configured for package delivery. Delivering a few light-weight packages on a route is fine but many more will inconvenience the mail carrier and slow delivery, or perhaps require an extra delivery trip. Again, the economy of scope proves illusionary.

With products that are farther afield from normal mail, economies of scope are even less likely to be realized. The "farm-to-table" program that began in 1914 and petered out after several years furnishes an interesting illustration of some of the problems.<sup>56</sup> The hope was that the Post Office Department could connect farmers and city dwellers by using post offices and the postal delivery system to process food orders and make deliveries. The program was undertaken with great enthusiasm, and Post Office employees devoted much time, thought, post office floor space, and the use of many delivery vehicles to the effort. Of course, all this was a distraction from the Post Office's normal business. Even though the Post Office apparently did not consider the significant opportunity cost involved, the program still withered. The agency proved ill-equipped to actively coordinate orders and properly handle perishable, delicate foodstuffs. As one historian wrote with regret, "Butter spoiled, potatoes froze, and eggs broke."<sup>57</sup>

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<sup>55</sup> When lower costs stem from economies of scope, they are a saving to the economy. Efficiency would not be served, however, in having the Postal Service undertake business activities in any cases where it is the low-cost producer because of factors such as tax exemptions and a preferential interest rate on borrowings that do not represent savings to the economy.

<sup>56</sup> See Wayne E. Fuller, *RFD: The Changing Face Of America* (Bloomington: Indiana University Press, 1964), pp. 228-259.

<sup>57</sup> *Ibid.*, p. 243.

The broader lesson is that the specialized training, procedures, and equipment best suited to delivering core postal products are often inconsistent with the specialized requirements of other products. Hence, while the postal monopoly offers modest economies of scope in some instances, it fails to do so most of the time.

Postal Service officials in the past, although much less so under Postmaster General Potter, have frequently claimed that the organization could capture substantial additional economies of scale and scope by entering new markets to become still larger. This claim was examined in detail in an earlier IRET study and found to be wrong, except for the modest "last mile" economies mentioned above.<sup>58</sup> The Postal Service is already so large that it has long since captured the size-based economies in administration, marketing, research, and operations often observed when comparing small businesses with businesses having several billion dollars in sales. If per unit costs continuously fell with larger size, as opposed to leveling off or rising after some point, the gigantic Postal Service should be the lowest cost producer in the mailing industry, and to maximize its size-based economies, it should want to do as much work in-house as possible. Instead, the Postal Service often finds that it can save money by doing less work in-house and hiring contractors to help with some production steps, such as transporting mail between cities. Similarly, if economies of scale dominated, worksharing (in which mailers do some preliminary mail processing in return for a discount that is normally set at or below the Postal Service's avoided costs) should rarely occur because mailers would have higher costs than the Postal Service due to their much smaller size. Instead, worksharing has proven such an enormous success for the Postal Service and mailers that the majority of mail today is workshared.

***Question 3 What other special advantages does the law grant to the Postal Service in its competitive product operations?***

The replies to Questions 1 and 2 have already discussed many of the benefits conferred by law on the Postal Service that are not available to its private-sector competitors. Question 8 mentions another: the ability to borrow from the U.S. Treasury at a low, government-based interest rate. Although it is not solely a matter of law, one of the largest advantages is the subject of Question 7: the Postal Service can aim for much lower returns on competitive products than its private-sector rivals because the federal government, which owns the Postal Service, has never required the government enterprise to strive for positive returns on its competitive products or pay dividends.

***Question 4 What are the Postal Service's special burdens in its competitive product operations, compared to normal businesses? Could any of those burdens be reduced for the Service's competitive products if they are kept for market-dominant products?***

In light of its many governmental powers and privileges, it might seem that the Postal Service should be on financial easy street. However, the Service also has numerous government-imposed

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<sup>58</sup> Schuyler, "Empire Building At The Postal Service," *op. cit.*

obligations, and it has struggled through most of its history. Benefits, burdens, and a weak bottom line are a combination often seen at government enterprises, here and abroad.

This answer lists and briefly discusses a number of the Service's special obligations. Most of the requirements apply to the Postal Service's operations in general and are not specifically aimed at the Service's competitive products, but a few involving regulation are directed at competitive products. Although the list is long and covers most special burdens, it is not comprehensive. Following the list, rough estimates are provided for some of the extra costs. There is also a brief discussion of whether it would be practical to remove the special obligations from competitive products if they continue for market-dominant products.

*Binding arbitration in certain labor disputes.* When the Service and one of its postal unions cannot reach a collective bargaining agreement, the matter goes to binding arbitration.<sup>59</sup> A plus for the Service in these disputes is that federal law prohibits strikes, but a minus is that an arbitrator with no financial stake in the Service dictates wages, some benefits, and some work rules. Hence, even when the Service thinks it is vital to stand firm on employee compensation, it lacks the power to do so. Occasionally, arbitration awards send shockwaves through the agency, as happened in 1999 when an arbitrator decided to move carriers up a pay grade.<sup>60</sup>

A ban on strikes is normal for the federal workforce, but binding arbitration is not. Most private-sector business would view the ban on strikes as an advantage, but the loss of control as a threat to their existence. PAEA slightly changed the dispute procedure by adding a short mediation phase, but that is unlikely to make a substantial difference.<sup>61</sup>

*Expensive fringe benefits mandated by statute.* At a time when many private-sector companies are responding to rising pension and health care costs by adjusting the benefit packages they offer, the Postal Service is locked in by statute to continue providing certain benefits regardless of cost. In Congressional testimony several years ago, Postmaster General John Potter expressed the issue's magnitude in dollar terms, "In 2003 alone, nonnegotiable benefit costs, including retirement contributions, health benefits, life insurance, retiree health benefits and workers' compensation represented more than \$13 billion – twenty percent of our operating expenses."<sup>62</sup> One minor change PAEA made was to impose a three day waiting period for benefits on temporary disability

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<sup>59</sup> PAEA, sec. 505, amending Title 39, U.S.C., sec. 1207.

<sup>60</sup> George R. Fleischli, Neutral Chair, "1999 Interest Arbitration," United States Postal Service and National Association Of Letter Carriers, AFL-CIO, accessed at <http://www.nalc.org/depart/cau/pdf/misc/flaward.pdf>.

<sup>61</sup> PAEA, sec. 505, amending Title 39, U.S.C., sec. 1207.

<sup>62</sup> John E. Potter, Postmaster General, U.S. Postal Service, "Testimony," Before a Joint Hearing of the Committee on Government Reform, United States House of Representatives, and the Committee on Governmental Affairs, United States Senate, March 23, 2004, originally accessed at <http://reform.house.gov/UploadedFiles/USPS%20Potter%20Joint%20Testimony.pdf>.

claims.<sup>63</sup> That was a desirable but very modest reform. Despite its modesty, the union-led reaction nearly torpedoed the bill.<sup>64</sup>

*Wage and employment laws that contractors to the federal government must follow.* In order to allow the Postal Service to operate on a more business-like footing, Congress has exempted it from many of the laws dealing with federal contracts.<sup>65</sup> However, a number of special requirements still apply. Some of them are the Davis-Bacon Act (relating to the wages that contractors must pay on government construction projects), the Walsh-Healey Act (relating to the wages and hours of contractors' employees), and the Randolph-Sheppard Act (relating to vending facilities operated by the blind on federal property).<sup>66</sup> These requirements raise costs for Postal Service contractors and some or all of the higher costs are passed along to the Service.

*Universal service obligation (USO).* The USO is not defined by statute, but today is usually thought of as meaning mail delivery to most addresses in the nation six days a week. It also means reasonable access to mail collection and counter services. The USO raises the government enterprise's costs. Its private-sector rivals in competitive markets generally have nationwide networks (or can provide links to nationwide networks) and deliver to most address because doing so increases the value of their services enough outweigh the costs.

*Restrictions on post office closings.* Private businesses are allowed to close retail outlets they decide are not cost effective. In a restriction related to the USO, however, the Postal Service cannot close small post offices solely for economic reasons.<sup>67</sup> Even when the Service wishes to close a post office for other reasons, it must go through a detailed review process and anyone in the community who disagrees with the Service may appeal to the PRC to block the closing.<sup>68</sup>

*Regulation of competitive product prices and product lines.* Private-sector businesses are subject to a blizzard of government regulations. However, when competition exists, government regulation of prices is rare, although there are exceptions, such as limited state regulation of insurance companies' rates. Similarly, the government does not usually regulate what products a firm may offer, although licensing requirements can be thought of as a huge exception and intense regulation is the norm in the pharmaceutical industry. At the Postal Service, the competitive products offered and the prices charged for those products have long been regulated. Under prior law, with a few

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<sup>63</sup> PAEA, sec. 901.

<sup>64</sup> See Michael Schuyler, "Union Demands Hurt Postal Service Reform," *IRET Congressional Advisory*, No. 210, October 11, 2006, available at <ftp://ftp.iret.org/pub/ADVS-210.PDF>.

<sup>65</sup> Title 39, U.S.C., sec. 410.

<sup>66</sup> *Ibid.*

<sup>67</sup> Title 39, U.S.C., sec. 101(b).

<sup>68</sup> Title 39, U.S.C., sec. 404(b).

exceptions, the Service could not change the price of any of its products, including competitive products, without first asking the PRC for approval and going through a formal hearing process. One of Congress's aims when designing PAEA was to give the Service more rate-setting flexibility. PAEA also differs from prior law in that it distinguishes between competitive and market dominant products and regulates the former more loosely.<sup>69</sup>

For competitive products, the Service can adjust prices with only a couple of restrictions. PAEA requires that no product loses money and that competitive products collectively make an appropriate contribution (with "appropriate" determined by the PRC) to overhead costs. These requirements clearly reflect a Congressional worry that monopoly-market customers might otherwise be forced to subsidize competitive products. The legislation explicitly instructs the regulator to "prohibit the subsidization of competitive products by market-dominant products."<sup>70</sup>

The possibility of cross-subsidization was also on Congress's mind when it directed the U.S. Treasury, in Title IV of PAEA ("Provisions Relating to Fair Competition"), to recommend accounting principles and practices for the Postal Service to follow in identifying competitive products' assets and costs. Congress noted that one of the objectives should be "preventing the subsidization of such products by market-dominant products..."<sup>71</sup> Congress's concern is understandable because while the profit motive automatically discourages deliberate and sustained cross-subsidization in the private sector, that market-based policing is lacking at government enterprises.<sup>72</sup>

PAEA does add one restriction: it removes the Postal Service's authority to introduce new nonpostal products<sup>73</sup> Several concerns may have prompted Congress's action.<sup>74</sup> One is that peripheral ventures are likely to distract the Postal Service and reduce the attention it pays to its core mission. Another is that the Service's nonpostal products have often lost money, thereby weakening the Service financially. Congress may also have been apprehensive that if the Service

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<sup>69</sup> PAEA, esp. sec. 201 and 202.

<sup>70</sup> PAEA, sec. 202, inserting Title 39, U.S.C., sec. 3633.

<sup>71</sup> PAEA, sec. 401, inserting Title 39, U.S.C., sec. 2011(h)(1)(A)(i)(II).

<sup>72</sup> For a fuller discussion of this point, see Michael Schuyler, "The Danger Of Monopoly-Subsidized Pricing By The Postal Service In Competitive Markets," *IRET Congressional Advisory*, No. 170, April 1, 2004, available at <ftp://ftp.iret.org/pub/ADVS-170.PDF>.

<sup>73</sup> PAEA, Sec. 102(a), amending Title 39, U.S.C., section 404(c). The provision also instructs the PRC to review each existing nonpostal product and determine whether it should continue.

<sup>74</sup> The bipartisan President's Commission on the U.S. Postal Service cogently explained why the Postal Service should concentrate on providing reliable, affordable mail service and should not the wander into other areas. See President's Commission on the United States Postal Service, *Embracing The Future; Making The Tough Choices To Preserve Universal Mail Service*, July 31, 2003, esp. p. 27, accessed at <http://www.treas.gov/offices/domestic-finance/usps/pdf/report.pdf>.

were allowed to use its government-based powers to venture deeper into competitive markets, it would replace more efficient private-sector businesses, which would be inefficient and unfair, and it would shift more economic activity off the tax rolls, which would weaken government finances. While Congress's concerns are warranted, competitive-product regulation does place some costs on the Postal Service that its private-sector rivals do not experience. (If, contrary to fact, the Service were not a monopolist and did not enjoy numerous government-based advantages, PAEA's restrictions on competitive product prices and product lines would not be justified.)

*Political jawboning, oversight, and the threat of legislation.* In addition to the requirements imposed upon it by law, the Postal Service often faces other types of pressure from Congress. Recently, for example, many members of Congress criticized the Service for outsourcing some mail deliveries, and over one-third of the Senate cosponsored a bill (S. 1457) to block the practice. The Postmaster General accurately responded that the contracting out is modest (confined to a small share of new delivery routes), a sensible way to reduce costs, and a good business practice.<sup>75</sup> Nevertheless, faced with Congressional pressure and union calls for binding arbitration, the Service agreed to new limitations on mail-delivery outsourcing. Similarly, Congressional pressure has slowed down and complicated the Postal Service's efforts to rationalize its nationwide network of processing facilities.

To be sure, congressional jawboning, oversight, and threats of legislation are sometimes desirable, such as when the Postal Service responds too slowly to service problems in a locality, but sometimes the pressure is aimed at protecting parochial interests and comes at the expense of best business practices. Although governments often pressure private businesses, they rarely do so with such frequency and at so detailed a level of business operations as with the Postal Service.

*Cost estimates.* As mentioned, most obligations that the federal government places on the Postal Service are not aimed at competitive products, but affect competitive products only because they are among the products the Service offers. For instance, statutory restrictions on the Service's control of its employees' wages and benefits raise production costs for both market-dominant and competitive products. Cost estimates are available in this and a few other areas, but they do not distinguish between market-dominant and competitive products. A reasonable rule of thumb in the absence of better information is that the Service's burdens raise costs on market-dominant and competitive products in the same proportion.

The PRC's Office of Rates, Analysis and Planning has carefully examined many of the costs related to the Postal Service's universal service obligation. As expected, the costs are substantial. However, they are not the immense burden that many imagine. The USO raises the Service's costs by only a few percent.

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<sup>75</sup> See John E. Potter, U.S. Postal Service, Postmaster General, Letter to Senator Thomas R. Carper, June 13, 2007, accessed at <http://ruralmailcarriers.googlepages.com/pottercds.pdf>.



Keeping small post offices open, which is one of the most conspicuous elements of the USO, is expensive in dollars but modest as a share of total costs. Closing the 10,000 smallest post offices would lower the Service's costs by less than 1%.<sup>76</sup> Rural delivery routes, which are another high-profile component of the USO, do not lose money on average and do not require cross-subsidies, except for extremely rural routes.<sup>77</sup> Part of the USO is serving new addresses, and the Service complains vociferously about the supposed burden of adding nearly two million addresses a year. However, an IRET study found that new addresses actually help the Service because the benefits from the extra business exceed the costs; new addresses are a plus, not a minus.<sup>78</sup> The PRC researchers came to a similar conclusion. It is not clear whether six-days-a-week mail delivery is really part of the USO. In any event, reducing deliveries to five days a week would lower the Service's costs by a maximum of 3%, although the actual savings would probably be much less.<sup>79</sup> Using two different assumptions about what services are only offered because of the USO, the PRC researchers came up with two upper-bound estimates for the USO's total addition to costs: 5% or 10% of the Postal Service's costs.<sup>80</sup>

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<sup>76</sup> Robert Cohen, Matthew Robinson, John Waller, and Spyros Xenakis, "The Cost Of Universal Service In The U.S. And Its Impact On Competition," Proceedings of Wissenschaftliches Institut für Kommunikationsdienste GmbH (WIK), 7th Koenigswinter Seminar on "Contestability and Barriers to Entry in Postal Markets," November 17-19, 2002, accessed at [http://www.prc.gov/tsp/114/cost\\_of\\_universal\\_service.pdf](http://www.prc.gov/tsp/114/cost_of_universal_service.pdf). The authors note that this is an upper bound on the cost saving and that the benefit to the Service's bottom line would certainly be less than 1%. The Service would lose some revenues due to decreased mail use and some costs would merely be shifted to remaining post offices. Also see Robert H. Cohen, Director, Office of Rates, Analysis and Planning, Postal Rate Commission, "Testimony Before The President's Commission On The Postal Service," February 20, 2003, accessed at <http://www.treasury.gov/offices/domestic-finance/usps/testimony-docs/Cohen.pdf>.

<sup>77</sup> Robert H. Cohen, William W. Ferguson, and Spyros S. Xenakis, Office of Technical Analysis and Planning, U.S. Postal Rate Commission, "Rural Delivery And The Universal Service Obligation: A Quantitative Investigation," July 31, 1992, published in Michael A. Crew and Paul R. Kleindorfer, Ed., *Regulation and the Nature of Postal and Delivery Services* (Kluwer Academic Publishers, 1993), accessed at <http://www.prc.gov/tsp/29/rural.pdf>.

<sup>78</sup> Michael Schuyler, "Does The Growing Number Of Homes And Businesses Help Or Hurt The Postal Service?" *IRET Congressional Advisory*, No. 219, February 15, 2007, available at <ftp://ftp.iret.org/pub/ADVS-210.PDF>.

<sup>79</sup> Cohen, Robinson, Waller, and Xenakis, "The Cost Of Universal Service In The U.S. And Its Impact On Competition," *op. cit.* The authors explain that 3% is an upper bound on the savings because they do not include in their calculation the delivery costs that would be shifted to the remaining five days. Nor do they include the revenues that would be lost.

<sup>80</sup> *Ibid.* Following a suggestion by economist John Panzar, the PRC researchers asked what services would be curtailed or eliminated if the Postal Services had no USO and were responding solely to market forces. The PRC researchers then based their estimates of the USO's costs on the costs of the services that were only provided because of the USO.

One provision in PAEA directs the PRC to prepare a study examining, in part, what the USO should look like in the future.<sup>81</sup> The PRC is to include in the report recommendations for adjustments it deems appropriate, with an indication of which adjustments the PRC could implement under current law and which would need legislation. Congress's request suggests members are aware that while the USO serves a valid public policy purpose, it has evolved over time and that the service standards associated with the USO have costs as well as benefits. Changes are most likely to spring from this study if the PRC finds that some features of the current interpretation of the USO have high costs, low benefits, and could be modified by the PRC under current law.

A much larger problem on the cost front – although it usually receives far less attention than the USO – is what the Service pays for labor. A number of economic studies have examined postal workers' compensation. Most have concluded that a substantial postal pay premium exists when postal wages and benefits are compared to what comparable workers earn in the private sector. Plausible estimates are that the pay premium is about 20% considering just wages and that it rises to about 35% when the Service's generous benefits, many mandated by Congress, are added.<sup>82</sup> (This is not to say that every postal worker receives above-market compensation. Postal employees who are unusually hard working, have in-demand skills, or work in high-cost-of-living areas are often paid at or below market rates.) The postal pay premium helps explain why nearly 80% of the Service's costs are labor related.

To gain some idea of how this affects the Service's level of expenditures, an illustrative calculation may be helpful. Suppose 75% of postal employees receive a pay premium averaging 30% compared to comparable workers in the private sector and suppose 25% of postal employees receive no pay premium. These are cautious assumptions and may understate the problem. Nevertheless, given these assumptions and remembering that about 80% of total costs are labor related, the Service's costs would be about 15% lower if not for the postal pay premium. In 2006, the dollar saving would have been about \$10.5 billion. This is between one-and-a-half and three times as large as the USO burden. When looking at the agency's cost challenges, labor compensation is the elephant in the room.

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<sup>81</sup> PAEA, sec. 702. The PRC study is also to examine the relation between the USO and the postal monopoly. Many economists would argue that the USO could be financed more efficiently and transparently through explicit Congressional appropriations or through licensing requirements placed on mail delivery companies. However, Congress instead created the postal monopoly to support the USO. Congress's request for this study indicates that it wants to hear the PRC's views on what role the postal monopoly should play in the future, but it is not clear if Congress is prepared to change the monopoly.

<sup>82</sup> For an overview of studies in this area, see Michael Schuyler, "The Postal Wage Premium: No Wonder The Postal Service Loses Money," *IRET Congressional Advisory*, No. 131, July 24, 2002, available at <ftp://ftp.iret.org/pub/ADVS-131.PDF>. Also see Michael L. Wachter, "Testimony of Michael L. Wachter," Before the Senate Committee on Governmental Affairs, February 4, 2004, accessed at <http://hsgac.senate.gov/files/020404wachter.pdf>; and Cohen, Robinson, Waller, and Xenakis, "The Cost Of Universal Service In The U.S. And Its Impact On Competition," *op. cit.*

The above-market labor compensation has multiple explanations, but it stems in part from the statutory constraints and political pressure under which the Postal Service must operate. Although the law twice directs the Postal Service to maintain pay comparability with the private sector,<sup>83</sup> the law provides no enforcement mechanism that would allow the Service to achieve that result. Nor is Congress likely to offer help in this area in the near future. In Congressional testimony, James Miller, the Chairman of the Postal Service's Board of Governors, observed that Congress could assist in moderating this problem but that in the past, "We have been told that the prospect of any relief on this score is nil."<sup>84</sup>

If Congress should eventually decide to tackle the postal pay premium, many options are available. Just to mention two possibilities, Congress could enact legislation instructing arbitrators to consider the Postal Service's finances, or Congress could abolish binding arbitration and allow the Service to decide what it will pay in accordance with Congressional guidelines, which is the normal procedure in the federal government.<sup>85</sup>

Given the array of constraints under which the Postal Service operates, Postmaster General Potter and his management team have done a remarkably good job in recent years. Although statutory requirements and political impediments place many costs beyond their reach, they have skillfully identified a number of inefficiencies and items of wasteful spending in areas within their control. Also, they have wisely recognized that the Service's success depends on how well it performs its core mission, and have devoted most of their energies to improving traditional mail service, not on casting about for new fields to enter.

*Can relief be provided just for competitive products?* In some cases Congress can ease the burdens on competitive products even if it wants to retain them (or relax them less) on market-dominant products. The most important example of this is rate regulation. As the centerpiece of PAEA,

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<sup>83</sup> Title 39, U.S.C., sec. 101(c) and sec. 1003(a).

<sup>84</sup> James C. Miller III, Chairman, Board of Governors, U.S. Postal Service, "Prepared Statement," before the Subcommittee on Federal Workforce, Postal Service, and District of Columbia, Committee on Oversight and Government Reform, April 17, 2007, accessed at <http://federalworkforce.oversight.house.gov/documents/20070504092753.pdf>.

<sup>85</sup> Many ways to narrow the postal pay premium are discussed in Michael Schuyler, "How to Bring Postal Into Line With The Private Sector," *IRET Congressional Advisory*, No. 132, August 28, 2002, available at <ftp://ftp.iret.org/pub/ADVS-132.PDF>. The suggestion of eliminating binding arbitration (postal workers would still be prohibited from striking) comes from Murray Comarow, who helped develop and implement the very successful Postal Reorganization Act of 1970. For a concise explanation, see Murray Comarow, "Response of Murray Comarow to the statements of Anthony J. Vegliante, U.S. Postal Service, William Burrus, American Postal Workers Union, William F. Young, National Association of Letter Carriers," April 29, 2003, before the Presidential Commission on the USPS, accessed at <http://www.postcom.org/public/2003/frommurray.htm>. The competitive labor market would protect workers because the Service would need to pay market-based wages and benefits in order to hire and retain the workers it needs. The gain to the Service would be that it would no longer have to overpay for labor.

Congress created a new, more flexible rate-regulation system for market-dominant products, and different, still looser rate-setting system for competitive products. (Congress sensibly did not abolish all rate regulation for competitive products. The rules now in place help protect customers within the postal monopoly, and also taxpayers, from being forced to cross-subsidize the Service's competitive products.)

In many cases, though, it would not be feasible to reduce the Postal Service's burdens on competitive products while leaving the requirements in place for market-dominant products. The reason is that the production of market-dominant and competitive products is often intertwined, involving the same workers and facilities. For instance, when political resistance slows the Service's efforts to streamline its nationwide facility network, the inefficiencies of the existing network increase costs for both market-dominant and competitive products.

***Question 5 How do the Service's burdens affect the costs and prices of its competitive products?***

The special constraints under which the Postal Service operate reduce its efficiency and raise its costs. The previous question discussed the cost burdens and estimated the size of several of them. Other things equal, the higher expenses force the Service to charge more for its products, including competitive products.

It is possible that the Postal Service's burdens will motivate the government enterprise to try harder in other ways to control its costs. If that happens, there will still be upward pressure on the Service's product prices, but not quite as much as otherwise. For example, postal workers' above-market pay packages undoubtedly generated much of the Service's interest in hiring contractors to deliver mail on some new routes at costs that are reportedly one half or two thirds of the Service's normal delivery costs.<sup>86</sup>

***Question 6 Should the Postal Service's government-based advantages be restricted with regard to its competitive products? Which government-based advantages can be removed from competitive products if they stay in place for market-dominant products? When the advantages take the form of tax and fee exemptions, can they be removed through internal Postal Service bookkeeping entries or should the Service actually pay the taxes and fees?***

As explained more fully elsewhere in this report, the Postal Service's government-based advantages reduce economic efficiency, decrease financial transparency, and narrow federal, state, and local tax bases. Restricting the Service's special powers and privileges with respect to its competitive product operations would yield welcome benefits. Allocative and productive efficiency would improve. The pruning back of what are, in effect, hidden and indirect government subsidies

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<sup>86</sup> See, for example, Jennifer Sorentrue, "Letter Carrier Shortage Spurs Privatization," *Palm Beach Post*, March 21, 2005, originally accessed at [http://www.palmbeachpost.com/localnews/content/local\\_news/epaper/2005/03/21/s1a\\_mail\\_0321.html](http://www.palmbeachpost.com/localnews/content/local_news/epaper/2005/03/21/s1a_mail_0321.html). As mentioned earlier, the Postal Service recently agreed to new limits on the outsourcing of mail delivery due to Congressional and union pressure.

would be a step toward more transparency. The broadening of tax bases would strengthen government finances.

A few advantages probably cannot be taken away from competitive products if the advantages remain in place for market-dominant products because market-dominant and competitive products are often processed in the same facilities and delivered by carriers on the same trips. Among the benefits that cannot easily be denied to competitive operations if they continue for market-dominant operations are the power of eminent domain, the ability to override local zoning requirements, and the exemption from parking tickets and various other municipal ordinances while delivering mail. However, many other advantages could feasibly be limited when the Postal Service steps outside its core mission and operates in competitive markets.

PAEA already moves modestly in that direction with the federal "assumed income tax" that was discussed earlier. The answer to Question 9 explains in detail how state and local taxes could be collected from the Service's competitive product operations. The answers to Questions 7 and 8 are also relevant because they discuss how two of the Service's other advantages could be reduced for competitive products but retained for market-dominant products.

With regard to the special benefits that could feasibly be denied to the Service's competitive product operations, should the Service merely have to note what its extra costs would be without those benefits or should it have to make actual payments to someone, and if so, whom?

The least effective option would be to establish only a reporting requirement. That option is better than nothing because it would increase transparency, but the Service would be unlikely to take much account in its decision making of costs it does not pay. A slightly better option would be to require the Service to estimate the cost savings and transfer that amount from the Competitive Products Fund to the Postal Service Fund. The weakness of this option is that it is an internal transfer. The organization might not view an internal transfer as a real cost unless it caused a competitive product to bump up against the statutory requirement that it not lose money or caused competitive products collectively to fall short of the requirement that they make an appropriate contribution to overhead costs.<sup>87</sup> A stronger option would be to require transfers from the Competitive Products Fund to the U.S. Treasury. To the Postal Service, such transfers would be real costs. But should all payments be sent to the U.S. Treasury? Many taxes and fees would normally be paid to state and local governments. Sending those taxes and fees to the U.S. Treasury would direct them to the wrong level of government and leave a hole in state and local finances. Those taxes and fees should be paid to state and local governments.

***Question 7 Should the Postal Service have to pay the federal government a return on capital?***

Under the terms of the Postal Reorganization Act of 1970, the federal government transferred many of the assets and liabilities of the old Post Office Department to its successor, the U.S. Postal

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<sup>87</sup> The requirements are specified in PAEA, sec. 201, inserting Title 39, U.S.C., sec. 3633.

Service. It was decided at the time that the federal government, in making the transfer, contributed \$3.034 billion of capital to the Postal Service.<sup>88</sup> Private-sector businesses are normally expected to pay investors a return on capital. A natural question, therefore, is whether the Postal Service should be required to pay a return on the capital that the federal government contributed to the Service's competitive product operations. The Service's competitive products are very similar to products sold by private-sector businesses and, unlike the core products delimited by the postal monopoly, lie outside the agency's government-assigned mission.

If the only issue here were the responsibilities stemming from a transfer that occurred in the early 1970s, it might not be possible to reach a firm conclusion. One difficulty is that although the federal government claims the initial capital contribution was \$3.034 billion, that amount was not determined in the marketplace, but by the government; the market might have placed a very different value on the transfer. Another difficulty is trying to figure out what share of the long-ago capital contribution should be attributed to today's competitive products. Further, one might ask whether the capital contribution should be listed at historic cost, be expressed in today's dollars by adjusting for inflation, or be compounded to what the original contribution would now be worth if it had been invested in securities earning the market interest rate. Moreover, in computing the government's capital contribution to the Postal Service, should some of the large federal appropriations that continued until the start of the 1980s be added in? Further, any decision now about whether to require the Postal Service to pay a return on the federal capital contribution would come too late to affect how the Service has used the capital contribution until now. As a general rule, disputes are likely to arise when attempts are made to revisit events from several decades ago.

This question is relevant and economically important, however, because it relates to a broader issue: the efficient use of capital in the future. For a healthier, more efficient economy, the Postal Service should begin paying a return on the capital invested in its competitive product operations.

When a private-sector business considers making an investment, the decision makers at the business normally have a target rate of return in mind and decline to make the investment unless they expect it to earn the target rate or better. The target rate of return has several components. First, assets must earn enough to cover their depreciation. Over and above depreciation, the business's owners want a satisfactory real return in their investment to compensate for postponing current consumption and forgoing other investment opportunities. Because investments are risky (some attractive investments will prove disappointing), investors also demand a risk premium to compensate for the projects that fail, based on the perceived riskiness of the investments and the owners' aversion to risk. Further, an inflation premium needs to be added to the real return to express it as a market rate measured in current dollars. Because investors are interested in the amount they can keep after paying taxes, they will take the after-tax rate of return they require and gross it up by taxes to find the required pre-tax rate of return. A project that is expected to break even but no better will certainly be rejected.

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<sup>88</sup> The Postal Service lists the amount each year in its Annual Report. See U.S. Postal Service, *Annual Report, 2006, op. cit.*, p. 60.

As an illustrative example, suppose that, beyond depreciation, the owners of a business desire an expected after-tax, real return of 3%, that the risk premium is 4%, and that the inflation premium is 3%. Given these assumptions, a potential investment would need to provide an expected after-tax, nominal return of about 10% to be attractive. If federal and state taxes at the corporate and individual levels on the business's investment income are 40%, a potential investment would need to offer an expected pre-tax, market return of at least 16.7%, over and above depreciation, to be judged worth doing.<sup>89</sup>

Investors act in their own self-interest when they evaluate potential investment projects. But in a good illustration of Adam Smith's invisible hand, they are serving a broader societal interest. Production resources are scarce and should not be wasted. When businesses compare potential investments to a target rate of return, they are weeding out projects that have little value, thereby leaving more resources available for consumption and investment opportunities that are valued more highly. By demanding a target rate of return, investors also help direct resources efficiently among firms: a firm that can put an investment to good use is more likely to pass the hurdle test and be able to obtain funds than a firm that is less efficient.

At the Postal Service, in contrast, Congress and the Service's managers have usually been pleased just to have the Service break even. If the Service were compared to a private-sector business in the illustrative example, the Service would be content to proceed with an investment that had an expected return 16.7 percentage points below what a normal business would demand. This discrepancy produces a misallocation of scarce production resources: the Postal Service will make investments that are much less valuable than alternative uses of the resources in the private sector. Further, because of some of the Service's other government-based advantages, such as not having to collect sales taxes, not paying property taxes on its assets, and being able to borrow funds at a below-market interest rate from the U.S. Treasury, it might happily proceed with an investment that is 20% or 25% less efficient than what would be required in the private sector.

It might be argued that Congress has decided to override market results in the case of the Postal Service's core products because Congress believes those products have a value that is not captured in the marketplace. However, even if this argument is accepted, it does not apply to the Service's competitive products, which lie beyond the Service's public policy mission and are very similar to products offered in the private sector. When the agency undertakes a competitive-product investment with a below-market expected return, it is harming the economy both by displacing more efficient private-sector firms in the same product lines and by diverting resources that would otherwise be used for higher valued purposes elsewhere in the economy.

Unfortunately, although it would be desirable if the Postal Service sought a target rate of return on competitive-product investments that is in accord with expected returns in the private

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<sup>89</sup> Businesses differ in whether they consider these factors by means of a formal decision process or rely on a gut decision. But a well-run business will weigh these factors.

sector, it is not clear how to achieve that result without having private owners (proprietors, partners, or shareholders) who clamor for market-based returns.

One imperfect option would be to follow the lead of several foreign posts that pay dividends to their governments. These foreign posts generally base their dividends on net income, and they include all income, not just income from competitive products. For example, Canada Post pays its "shareholder", the Canadian government, dividends equal to 40% of its net income, which amounted to \$48 million (Canadian dollars) in 2006 and \$80 million in 2005.<sup>90</sup> New Zealand Post paid dividends of approximately \$48 million (New Zealand dollars) in 2006.<sup>91</sup> Sweden Post reports that its policy is to pay the government dividends amounting to 40% of net earnings, but it cut dividends to 12% in 2005 due to financial uncertainty.<sup>92</sup> Sweden Post also reports that government companies "which operate in markets subject to competition are required to produce returns on investment."<sup>93</sup> One of Sweden Post's internal targets is achieving a 10% return on equity. As is normal with dividends, these payments are made to the equity owner, and are not merely transfers within the enterprise. Net earnings that stay within the enterprise are not dividends at all but retained earnings. If the Postal Service, unlike the foreign posts just mentioned, is not required to pay a dividend, it should at a minimum and for the sake of financial transparency show on its books, as an implicit government subsidy, the forgiveness of the dividend. The practices of foreign posts might be used as a guide when deciding on the dividend rate.

For the U.S. Postal Service, the dividend calculation could be modified to apply only to net income on competitive products, if desired. If that were done, the dividend would be paid out of the Competitive Products Fund and sent to the U.S. Treasury.

Many observers would view dividends as a means of paying the federal government back for its initial investment in what has become the Postal Service's competitive product operations.<sup>94</sup> The forward-looking economic justification, though, is that if the Service has to pay dividends, it will view its competitive product operations as more akin to normal business activities and set an internal rate-of-return target for them more in line with what is used by other businesses. A weakness of this approach is that establishing a dividend based on some portion of net income

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<sup>90</sup> Canada Post, *Annual Report, 2006*, p. 31, accessed at [http://www.postescanada.ca/corporate/about/annual\\_report/pdf/mda\\_financials\\_2006\\_e.pdf](http://www.postescanada.ca/corporate/about/annual_report/pdf/mda_financials_2006_e.pdf).

<sup>91</sup> New Zealand Post, *Financial Statements 2005/2006*, p. 54, accessed at <http://www.nzpost.co.nz/NZPost/Images/NZPost/PDF/FinancialStatement.pdf>.

<sup>92</sup> Posten AB, *Annual Report, 2005* (English version), p. 4, accessed at <http://hugin.info/134112/R/1053089/175010.pdf>.

<sup>93</sup> *Ibid.*

<sup>94</sup> This basic characteristic of a dividend would be entirely lost if the "dividend" were merely a transfer within the Postal Service, from the Competitive Products Fund to the Postal Service Fund.



would not actually compel the Postal Service to establish a market-based rate-of-return target for its competitive products.

Another imperfect option has the advantage that it would give the Postal Service a more direct incentive to raise its rate-of-return target on competitive product investments, but the disadvantage that it is an unusual way to calculate a dividend. The dividend would be set at some percentage of competitive product assets, and paid from the Competitive Products Fund to the U.S. Treasury. The logic is that if the Postal Service knew it would have to pay a set return on investment projects, it would quickly raise its target rate of return on new competitive product investments by several percentage points. This would narrow the gap between target returns at the Postal Service and in the marketplace, although it probably would not eliminate the gap. A variation that might more closely align the dividend with new investment decisions would be to apply the dividend only to new competitive product investments. Like a preferred stock dividend, this dividend could be suspended if the Postal Service stated that its financial results were disappointing and decided (perhaps with input from its regulator) that it temporarily lacked the capacity to pay.

***Question 8 Should the Postal Service pay a market-based interest rate, not the current preferential rate, when it borrows for its competitive product operations? Is there a feasible way to do this?***

The Postal Service is able to borrow from the Federal Financing Bank at several basis points above the U.S. Treasury's own cost of funds. The Treasury interest rate is significantly lower than even the most credit worthy private-sector business can obtain because lenders think Treasuries are free of default risk. The government borrowing window enables the Postal Service to borrow at substantially less cost than if it were a private-sector company possessing the Service's revenues, costs, and future prospects.

As an illustrative example, suppose the 10-year Treasury rate is 4.9% and the Baa rate is 6.5%.<sup>95</sup> Suppose also that the Postal Service can borrow at 15 basis points above the Treasury rate because of its governmental status but that it would be rated Baa if it were a private-sector company. Given these illustrative assumptions, the Postal Service receives an implicit interest rate subsidy of 1.45 percentage points from the Treasury on every loan, and it saves \$14.5 million annually on each \$1 billion it borrows. The subsidy would grow if the Service borrowed more. At the end of 2006, the Service's debt was \$2.1 billion.<sup>96</sup> Borrowing that amount under this example's assumptions would provide an interest rate subsidy of \$30.45 million.

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<sup>95</sup> These numbers are close to the actual 10-year Treasury and Baa rates, as reported by the Federal Reserve, for June 5, 2007. (See Federal Reserve, H. 15, Selected Interest Rates, accessed at <http://www.federalreserve.gov/releases/h15/update>, for June 5, 2007.)

<sup>96</sup> U.S. Postal Service, *Annual Report, 2006*, p. 3, *op. cit.*

The interest rate advantage lowers the Postal Service's costs. It is not clear, though, how the Service uses that indirect government assistance. Other things equal, the artificially low interest rate might hold down prices for the Service's products. However, if the bargain interest rate lulls the Service into being less vigilant about watching its other costs, the indirect subsidy might be expended on higher costs elsewhere. Costs might also rise because the statutory limits that Congress has placed on the Postal Service's control of its labor costs may allow labor to capture the savings from the indirect interest-rate subsidy.<sup>97</sup> Moreover, if some of the subsidy reaches customers, it is unclear how the Service would divide the savings between its monopoly-market and competitive-market customers. The former are more closely tied to the Service's mission, but the Service might try to favor its competitive-market customers because they are more price sensitive since their ability to purchase alternative products is not restricted by the postal monopoly.

On the issue of how to determine whether a borrowing is used to support the Postal Service's market-dominant or competitive products, one option would be to rely on how the agency says the borrowing is used. A drawback to this allocation method, however, is that because money is fungible, the Postal Service might be able artificially to shift some borrowings from the competitive to the market-dominant category, especially if a significant interest rate differential gives it a motive to do so. Another option would be to base the allocation on asset shares. Because borrowings are often used to finance investments, it is appealing to assume that borrowings are divided between the two categories according to the shares of assets in the categories. A concern, though, is that the allocation of assets between the categories is itself subjective. A third option would be to allocate borrowings based on revenue shares for the competitive and market-dominant categories. This method, which was mentioned in several earlier responses, has the attraction that revenue shares can be calculated objectively because the Service compiles accurate data on the revenues of each product.

To remove this hidden government subsidy, the Postal Service should have to pay an interest rate equal what it would be charged if it were a private-sector company with the Service's balance sheet, income statement, and business prospects.

Requiring the Postal Service to borrow in private credits markets, however, would not achieve this result and would create serious moral hazard dangers. Lenders would reasonably assume that Washington would never let the U.S. Postal Service default on its debt obligations and enter bankruptcy, even if the Service and the U.S. Treasury explicitly denied that the debt obligations were guaranteed by the Treasury (and ultimately taxpayers). Accordingly, private lenders would be glad to lend an almost unlimited amount to the Postal Service at just slightly above the U.S. Treasury rate.

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<sup>97</sup> The large postal pay premium discussed earlier suggests that many of the benefits from the Service's government-based advantages flow to labor. Also, for an earlier IRET study that explained how labor might emerge as the principal beneficiary of a government enterprise's direct and indirect subsidies, see Stephen J. Entin, "The Postal Service: A Monopoly That Loses Money," *IRET Congressional Advisory*, No. 130, June 3, 2002, available at <ftp://ftp.iret.org/pub/ADVS-216.PDF>.

One sees this type of behavior and where it may lead in the response of financial markets to government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac. Those two GSEs are privately owned but have retained enough government ties that lenders regard them as being federally insured, despite the government's explicit denial that any guarantee exists. Fannie and Freddie have parlayed their implicit federal guarantee and associated interest rate advantage into domination of the U.S. single-family mortgage market.<sup>98</sup> Indeed, the GSEs have become so large that Alan Greenspan warned, when he was Federal Reserve chairman, of possible systemic risks to U.S. financial markets if Fannie and Freddie continued expanding.<sup>99</sup>

A feasible solution would be to have the Postal Service continue borrowing from the Federal Financing Bank, while directing the Treasury to set the interest rate equal to what a private-sector company with business risks similar to the Service's but no ties to the government would have to pay in the credit market.

If the policy decision were made to charge a market-based rate only on competitive products (i.e., retaining the preferential interest rate on market-dominant products), that could also be done. The Treasury would use a blended interest rate, obtained by weighting the preferential and market interest rates according to the shares of Postal Service products in the market-dominant and competitive categories. The Postal Service would pay this rate to the Treasury on borrowings. To hold market-dominant products harmless, Service's Competitive Products Fund would be responsible for paying the difference between the blended rate and the preferential rate.

Would it be as effective to allow the Postal Service to continue receiving the preferential interest rate on all its borrowings, but require an internal transfer from the Competitive Products Fund to the Postal Service Fund? The internal transfer would be equal to the difference between the blended and preferential rates multiplied by borrowings. This would be better than nothing because competitive products would be charged a market-based interest rate, but it would be less likely to instill market discipline than a payment to the Treasury because the Postal Service might not regard internal transfers as real costs, unless the transfers caused competitive operations to violate the statutory requirements that none of them lose money and that they collectively make an appropriate contribution (as determined by the PRC) to overhead costs.

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<sup>98</sup> For a fuller discussion of this issue, see Michael Schuyler, "Limiting The Postal Service's Interest Rate Subsidy; A Lesson From Fannie Mae And Freddie Mac On What Would Work And What Would Not," *IRET Congressional Advisory*, No. 178, August 10, 2004, available at <ftp://ftp.iret.org/pub/ADVS-178.PDF>.

<sup>99</sup> Alan Greenspan, "Testimony of Chairman Alan Greenspan; Government-Sponsored Enterprises," Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 24, 2004, accessed at <http://www.federalreserve.gov/boarddocs/testimony/2004/20040224/default.htm>.

***Question 9 Should the Postal Service have to pay normal state and local taxes on its competitive product operations? Would this be administratively feasible?***

Requiring the Postal Service to pay state and local taxes on its competitive products would be economically desirable and administratively feasible. The current exemptions of its competitive product operations from many state and local taxes invite economic distortions.

*Rationales for the tax exemptions.* Consider a best-case argument for continuing the tax exemptions. The Postal Service hopes its competitive-market products will earn profits, and it claims that the profits will be used to cross-subsidize the Service's core products to hold down their rates. In this scenario, the cost savings due to state and local tax exemptions bolster profits and increase cross-subsidies to the products that are the focus of the Service's government-assigned mission. Even in this best case, two concerns exist. One is that this is a roundabout and non-transparent way to deliver a subsidy. By hiding some of the costs of the Postal Service's core products, the cross-subsidies would make it harder for citizen/voters to judge whether the Postal Service provides good value for the money. A second negative is that by removing some normal business activities from state and local tax bases, the federal government is weakening state and local finances and violating the spirit of fiscal federalism. To offset the lost taxes, states and localities must reduce their services or tax remaining taxpayers more heavily.

A different possibility is that the Postal Service might pass along the cost savings from its state and local tax exemptions to competitive-product buyers. This would be good for purchasers of the Service's competitive products, but, as in the first case, it would weaken state and local governments' finances by shrinking their tax bases. Because buyers of the Service's competitive products would tend to increase their purchases due to the artificially low prices, this scenario would result in allocative inefficiency: too much of the subsidized products and too little of other products. Also, if the Postal Service takes business away from more efficient private-sector companies as a result of its tax-based cost savings, efficiency in production would be hurt.

Another possibility is that the cost savings from its state and local tax exemptions might make it harder for the Postal Service to exercise proper financial discipline, with the result that its other costs would rise. It is relevant in this context that nearly 80% of the Service's costs are labor related, and, as mentioned in Question 4, there is much evidence that the current binding-arbitration method for resolving collective bargaining disputes leads to above-market wages and benefits. If arbitrators base their decisions in part on how much they think the Service can afford, some of the money the Service does not pay in state and local taxes may be transformed into higher wages and benefits when arbitrators make their awards. Such transfers serve no valid public policy purpose.

In short, the hoped for benefit from exempting the Postal Service from many state and local taxes is cross-subsidies to its core products. It is by no means clear that this hoped-for benefit is realized. Whether or not it is realized, the costs of the exemptions are a weaker economy due to reduced allocative and productive efficiency, weaker state and local government finances, and less

transparency in federal government finances. Hence, removing the exemptions would be economically desirable. The next question is feasibility.

*Feasibility.* The responses to several earlier questions have discussed practical methods for limiting some of the Postal Service's government-based advantages in its competitive product operations. To complement the earlier discussion, it might be helpful to examine some evidence gained from the taxation of private-sector businesses.

Would it be feasible to require the Postal Service to collect normal sales taxes on its competitive products? Although complying with the requirements of numerous taxing jurisdictions has significant costs, many large retail chains with brick-and-mortar stores across the nation already do that. If they can comply, the Postal Service should be able to do the same.

It might seem as though the Postal Service would confront a special challenge because some of its products would be subject to sales taxes (competitive products) and some would not (market-dominant products). In fact, it is a challenge with which private-sector businesses must often cope. In many jurisdictions, retail stores, including small ones, sell some items that are tax exempt, some that are taxed at a standard rate, and some that are taxed at higher or lower rates. Computer software helps in calculating sales tax at the cash register, and the Postal Service would enjoy economies of scale in installing the needed software.<sup>100</sup>

Could state and local income taxes be applied to the Postal Service on its competitive products? Most states have income taxes, and private-sector businesses comply with them. Income tax compliance is costly, but experience with private sector businesses has shown that it is feasible. The Postal Service would have the advantage that there are economies of scale in tax compliance. (Other things equal, income tax compliance costs per dollar of sales or assets fall rapidly as a company grows.) Many studies have investigated income tax compliance costs, and some have specifically looked at the relationship between those costs and company size.

An especially useful study for assessing tax compliance costs at very large companies was done by Slemrod and Blumenthal for the Tax Foundation in the early 1990s, and published by the Tax Foundation in 1993.<sup>101</sup> Slemrod and Blumenthal used a survey to gather data from large

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<sup>100</sup> This is not to dismiss the substantial burden that tax compliance costs impose on the U.S. economy and on individual businesses and households. The costs are steep, and they are a deadweight loss to the economy. For that reason federal, state, and local governments should work harder to reduce the enormous complexity of their tax systems. The question here is the different one of whether those costs would be so high for the Postal Service that the Service should be exempted from all state and local taxes. Some taxes with extremely high compliance costs should be restructured or eliminated, but that should be done for all taxpayers, not just the Postal Service.

<sup>101</sup> Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," Tax Foundation, November 1993, accessed at <http://www.taxfoundation.org/files/a3a792509ccb161d00a8895e31cb90ba.pdf>.

companies, including a subsample of the Fortune 500. They asked about federal, state, and local income tax compliance costs. Among the compliance costs about which they inquired were tax planning, tax-form preparation, audits, and litigation. For their subsample of Fortune 500 companies, they estimated that income tax compliance costs averaged about \$2,110,000 per company in 1992. Approximately 70% of the estimated income tax compliance costs were at the federal level and about 30% at the state and local levels.

A more recent study that Slemrod and Venkatesh prepared for the Internal Revenue Service reported similar findings.<sup>102</sup> They concluded that tax compliance costs per dollar of company assets fall rapidly until company assets reach the \$2 billion - \$3 billion range and level off thereafter. Moody, Warcholik, and Hodge reached similar conclusions in a 2005 study for the Tax Foundation.<sup>103</sup> Using these studies as guides, the Postal Service's competitive product lines, by themselves, are more than large enough to capture all significant economies of scale in income tax compliance costs.

In calculating state and local income taxes, the Postal Service would have a head start because PAEA directs it to calculate a federal "assumed income tax" for its competitive product operations, and an intermediate step is computing its competitive-products income. Perhaps the Service would be allowed simply to drop that income number into its state and local income tax computations.

Requiring the Postal Service to pay income tax on its competitive products (but not its market-dominant products) is similar in concept to the unrelated business income tax (UBIT), which taxes non-profit organizations on business activities that are unrelated to their public service missions. Federal law states that "income derived by any [exempt] organization from any unrelated trade or business...regularly carried on by it" is considered unrelated business income and is subject to federal income tax.<sup>104</sup> The federal government adopted the UBIT in 1950. Some states also have UBITs.

Non-profit organizations are generally not subject to income taxes when carrying out their primary missions. The exemption is politically popular and based on the notion that because non-profits provide useful services intended to help some or all of society (frequently offering alternatives to government services), they deserve indirect government support. When exempt

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<sup>102</sup> Joel Slemrod and Varsha Venkatesh, "The Income Tax Compliance Cost Of Large and Mid-Size Businesses," A Report to the IRS LMSB Division, Submitted by the Office of Tax Policy Research, University of Michigan Business School, September 5, 2002, accessed at <http://www.bus.umich.edu/OTPR/WP2004-4.pdf>.

<sup>103</sup> J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," *Special Report*, No. 138, Tax Foundation, December 2005, accessed at <http://www.taxfoundation.org/files/sr138.pdf>.

<sup>104</sup> Internal Revenue Code, Section 512. Section 513 adds, "The term 'unrelated trade or business' means ... any trade or business the conduct of which is not substantially related ... to the exercise or performance by such [exempt] organization of its charitable, educational, or other purpose or function constituting the basis for its exemption..."

organizations operate trades or businesses not related to their primary missions, however, this justification no longer applies.

Instead, the concern arises that if the organizations can operate commercial business without paying tax on their business profits, they would have a powerful government-bestowed tax edge that would often let them displace other commercial businesses. Such a result would be allocatively and productively inefficient, unfair to the owners and employees of taxable businesses, and a threat to government revenues (especially as non-taxable businesses forced out more and more taxable ones.) Referring to a case in which a university owned a large, commercial company that made and distributed pasta, a member of Congress complained that if the university-owned macaroni company could earn profits without paying tax, "all the noodles produced in this country will be produced by corporations held or created by universities."<sup>105</sup>

An ongoing problem in administering and enforcing the UBIT is trying to distinguish between philanthropic missions and unrelated activities, especially in borderline cases. Fortunately, PAEA draws a bright line between the Postal Service's market-dominant and competitive products.

When businesses operate in multiple states, another important issue is how to apportion their income among the states. As a practical matter, states generally use fairly simple weighting schemes to determine for tax purposes what fraction of a company's income occurs within their borders. An idea developed in the 1950s was model legislation known as the uniform division of income for tax purposes act (UDITPA). In states that have adopted UDITPA, a business's income is apportioned for tax purposes between in-state and out-of-state income based on three factors weighted equally: the share of the company's property within the state, the share of the company's sales to state residents, and the share of the company's payroll to state residents. Currently, though, most states use apportionment formulas that emphasize sales. A few base the allocation only on sales and many weight sales twice as heavily as other factors.<sup>106</sup> Notice that in addition to using simple formulas, most state weighting schemes rely on relatively objective and observable data.

For the Postal Service, an apportionment formula based on sales would best meet the practicality test, and would be in line with what is often seen at the state level. Competitive-product income would simply be multiplied by the fraction of total competitive-product sales occurring within the state or locality to determine how much income would be taxable within the

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<sup>105</sup> Representative Dingell, Revenue Revision Of 1950: Hearings before the House Committee on Ways and Means, 81st Congress, 2nd Session, pp. 579-80, cited in Ellen P. Aprill, "Excluding The Income Of State And Local Governments: The Need For Congressional Action," *Georgia Law Review*, Winter 1992, pp. 421-502. In the pasta-factory case, New York University owned the C. F. Mueller Company.

<sup>106</sup> For apportionment formulas for general manufacturing businesses as of January 1, 2007, see Federation of Tax Administrators, "State Apportionment Of Corporate Income," accessed at <http://www.taxadmin.org/FTA/rate/apport.pdf>.

jurisdiction.<sup>107</sup> As already mentioned in earlier responses, the Service collects detailed, objective data on each product's revenues. (If the Service does not already break down sales by locality, it should be able to add that information fairly easily going forward.)

Similarly, with property taxes, experience with private-sector businesses teaches that it would be feasible to tax the Postal Service on the assets of its competitive product operations. When a private-sector businesses own properties in many jurisdictions, it must pay property taxes in those many jurisdictions. In the case of the Postal Service, localities would appraise the value of Postal Service properties within the locality in the same manner as they do for business properties. One more step is needed and it might initially seem insoluble: how do localities distinguish between taxable competitive product assets and tax-exempt market-dominant product assets? As suggested above, however, one practical solution would be to take the ratio of competitive-product revenues to total revenues to compute the fraction of property values that would be taxable. Like many rules currently used in business and individual tax computations, this rule is simpler than reality but is administratively workable.

What laws would need to be changed before any of this could happen? The Supreme Court ruled in 2004 that because of the Postal Service's position within the federal government, it is not subject to some laws that apply to private persons.<sup>108</sup> Although the ruling did not address state and local tax laws, the Court's logic indicates that many state and local taxes cannot currently be applied to the Service. The Court also noted that Congress has the power to change the law in order to remove various Postal Service exemptions, if Congress thinks that appropriate. Hence, a reasonable conclusion is that before state and local governments could tax the Postal Service's competitive product operations as though they were the operations of a normal business, Congress would need to pass legislation explicitly authorizing the taxation. Capitol Hill has no inclination at this time to pass any such law, but it would be feasible if Congress changes its mind in the future.

If enabling legislation were to be enacted in the future, Congress might wish to include several provisos. To protect the Postal Service from discriminatory local taxation, one would be that its properties could not be valued at a higher rate than the properties of private businesses. To simplify the Service's income tax calculations, another would be that its competitive product income for state and local tax purposes should be the same as the competitive product income derived on its federal "assumed income tax" schedule. To provide consistency in the apportionment of the Service's income across jurisdictions, Congress might also want to specify the apportionment formula. (One of the most frequent complaints by businesses about state allocation formulas is that

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<sup>107</sup> For instance, if the income imputed to competitive products is \$300 million, and if the share of competitive product sales occurring within a particular state is 2%, the share of competitive products income allocated to that state would be \$6 million.

<sup>108</sup> U.S. Supreme Court, *United States Postal Service v. Flamingo Industries (USA) Ltd. et al.*, *op. cit.*



they are often inconsistent across states, with the result that businesses are sometimes taxed by more than one state on the same income.)

Conceivably, Congress might decide that the Postal Service's competitive product operations should make payments to state and local governments but be reluctant to permit taxation. An alternative used with some government agencies and programs would be payments in lieu of taxes. For example, federal law expressly exempts the federal government's Tennessee Valley Authority (TVA) from all state and local taxes but directs TVA to pay 5% of its gross revenues to the states and localities in which it carries out its power operations.<sup>109</sup> In 2006, TVA's payments in lieu of taxes totaled \$376 million.<sup>110</sup> As another example, Congress annually appropriates money for the Payments in Lieu of Taxes (PILT) program, which partially compensates local governments for the property taxes they lose due to tax-exempt federal properties within their borders.<sup>111</sup> PILT compensation will total \$232 million in 2007.<sup>112</sup> Canada also operates a PILT program, which pays local governments more than \$460 million yearly to compensate for lost property tax revenues.<sup>113</sup> If such a program were implemented for the Postal Service's competitive products, Congress would set the reimbursement formula, and payments would be made from the Competitive Products Fund to states and localities. A drawback to payments in lieu of taxes, though, is that they may deviate significantly from what state and local taxes would be.

***Question 10 Should the Postal Service have to spin off its competitive product operations?***

Would it be feasible to establish a separate private entity to provide competitive products? What would be the costs and benefits? The answer depends on whether the Postal Service's competitive products would be spun off to an independent company with no government ties or to a "private" company tied to the Postal Service or the general government.

First, suppose the Postal Service is required to sell its competitive product operations to a private-sector company that would have no ties to the Postal Service or the general government after the spin-off. The private company might be a business already in the field or a new entrant.

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<sup>109</sup> Tennessee Valley Authority Act Of 1933 (Title 16, U.S.C., sec. 831).

<sup>110</sup> Tennessee Valley Authority, *Annual Report, 2006*, p. 24, accessed at [http://www.tva.gov/finance/reports/pdf/tva2006\\_annual\\_report.pdf](http://www.tva.gov/finance/reports/pdf/tva2006_annual_report.pdf).

<sup>111</sup> Title 31, U.S.C., chapter 16.

<sup>112</sup> See U.S. Department of the Interior, "Local Governments To Receive \$232 Million In Federal Compensation For Non-Taxable Federal Lands," News Release, June 15, 2007, accessed at [http://www.doi.gov/news/07\\_News\\_Releases/070615.html](http://www.doi.gov/news/07_News_Releases/070615.html).

<sup>113</sup> See Public Works And Government Services, Government of Canada, "Welcome to Payments in Lieu of Taxes (PILT) Program," accessed at <http://www.pwgsc.gc.ca/pilt/text/index-e.html>, and "Frequently Asked Questions," accessed at <http://www.pwgsc.gc.ca/pilt/text/faq-e.html>.

Probably the main uncertainty in this case is whether the acquiring business would obtain much of value, and, hence, be willing to pay the Postal Service much. Because most of the Postal Service's facilities, equipment, and workers help process both market-dominant and competitive products, it is not clear how many production assets and skilled employees could be transferred to the spin off. Further, because postal plants and equipment have often been built and workers hired and trained with dual uses in mind, many of the production assets and workers transferred to the spin-off could not initially be employed in full accord with their design and training. Also, while brand names like priority mail and express mail undoubtedly have market value, but it is uncertain how much. A thorough analysis by investment bankers and other specialists on acquisitions and divestitures could help answer these questions.

If a spin-off were judged to be feasible, the acquiring firm would have a strong incentive to be efficient, innovative, and responsive to customers because that behavior would lead to higher profits. Given that the acquiring firm would have no special relationship with the government, its actions would not be distorted by the special burdens and privileges that accompany government ownership or sponsorship. Those improved incentives would tend to raise output, incomes, productivity, and real wages.

A negative is that some customers might be inconvenienced because they could no longer obtain competitive products at the local post office. Market forces would quickly ease the inconvenience, however. The acquiring company would add outlets to accommodate the extra business, and if it were slow to do so, the behavior of retailers in other industries suggests that competitors would see an attractive business opportunity and jump in with extra locations of their own. Further, the Postal Service could allow the acquiring company to sublease space at local post offices and offer the products there, at least during a transition period. Experience with groceries, drug stores, gas stations, and financial outlets suggests that at the end of the process consumers would likely have a greater range of convenient options than they do today.

Of course, before any spin-off could occur, Congress would have to decide that it is good public policy and pass legislation explicitly authorizing the restructuring. Fierce political opposition from many quarters might deter Congress from acting.

It should also be mentioned that if the removal of competitive products from the Postal Service were to produce diseconomies of scale and scope at the Service, it is plausible that their addition to the product offerings of the acquiring business would generate economies of scale and scope there. Because of that offset, diseconomies of scale and scope would be a smaller problem for the economy as a whole than it would seem from looking at the Postal Service in isolation.

In contrast to the case just outlined, suppose that Congress were to create a "private corporation" wholly owned by the Postal Service and require that the Service transfer its competitive products to the "private" company. It is assumed that Congress would order the Service and the Service's offspring to determine an appropriate division of assets and liabilities, probably with regulatory supervision. It is further supposed that Congress would specify that the

spinoff company would be subject to all the taxes, fees, regulations, and other laws that normally apply to private-sector businesses and would also specify that the offspring's debts would not be backed by the Postal Service or the U.S. Treasury.

Unlike the first case, the parties would not be at arms length because the Postal Service would own the "private" corporation. This shared ownership and the resulting lack of independence would likely affect the initial division of assets and subsequent operations. For example, the parties might allocate a large share of owned properties to the Postal Service to hold down local property taxes and a higher-than-arms-length share of costs to the offspring to reduce income taxes. (The Postal Service would be tax exempt but the "private" corporation would not be.) The Congressional legislation requiring the Postal Service to split off its competitive products would undoubtedly include rules to try to make the parties behave as though they were at arms length, and the enhanced accounting system that PAEA calls on the U.S. Treasury and the PRC to develop for the Postal Service should also help. Still, such rules might be difficult to police because it would often be in the interest of the parties to behave collusively.

Moreover, because the new corporation's owner would be a government entity rather than profit-maximizing investors, the corporation would probably be less motivated than an ordinary business to reduce costs, raise productivity, and move quickly to satisfy consumers' wants. Congressional interference would also be more likely. These factors make it doubtful whether spinning off the Postal Service's competitive products into a new company wholly owned by the Service would achieve much in terms of greater economic efficiency.

A major concern is how financial markets would react to the Postal Service's offspring. As mentioned in the response to Question 8, the behavior of financial markets toward GSEs like Fannie Mae and Freddie Mac indicates that if a spinoff company owned by the Postal Service were allowed to borrow in the marketplace, lenders would treat the spin-off as being federally insured, despite the government's explicit denial that any guarantee exists. Hence, the spinoff would retain the extremely powerful government-based advantage of being able to borrow at preferentially low interest rates.

The discussion of a "private" corporation owned by the Postal Service is based on an option that Congress actually considered. PAEA emerged from an evolutionary process that included a number of prior legislative proposals. Some of them would have established a "USPS corporation" that could offer, without restriction, postal products outside the mail monopoly and nonpostal products.<sup>114</sup> Further, the proposals would have authorized the USPS corporation to borrow in private credit markets, acquire shares of other companies, and form joint ventures with other companies. If the USPS corporation had been created, it could have been able to expand in businesses throughout the economy because of its preferential interest rate, not by virtue of superior

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<sup>114</sup> See section 204 of the version of H.R. 22 agreed to by the Subcommittee on the Postal Service on September 24, 1998 (the "Postal Modernization Act of 1998"), and section 204 of the version of H.R. 22 introduced on January 6, 1999 (the "Postal Modernization Act of 1999").

efficiency. The economy's efficiency and vibrancy would have suffered. Fortunately, Congress soon thought better of this idea and dropped it from later versions of the bill.

Given the meager benefits and significant dangers of spinning off competitive postal products to a "private" company owned by the Postal Service, that approach should be firmly rejected.

***Question 11 Are there other possibilities for ending the Postal Service's government-based advantages and disadvantages on its competitive product operations?***

It has been assumed throughout this study that the postal monopoly remains in much its current form. Obviously, if Congress should decide at some future point to alter the monopoly, such as by emulating the de-monopolization that is underway in the European Union, many options not considered here would become possible.

**Conclusion**

Some of the Postal Service's government-conferred advantages and burdens are closely linked to its assigned mission of non-urgent, hard-copy letter delivery. However, many are not. It would be administratively practical to prevent the Service's competitive products from claiming a number of current advantages, notably tax and fee exemptions and a below-market interest rate, without compromising the Service's market-dominant product operations. Doing so would help the economy and support competition. Feasible options also exist for easing some of the Service's burdens, particularly those involving labor costs, without interfering with its core mission and without relaxing regulatory protections that are needed because of the Postal Service's monopoly and other powers. Lessening those unnecessary burdens would allow the Service to perform its core tasks better and improve economic efficiency.

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