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Reverse Privatization: The Expanding Postal Service

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In recent years the United States Postal Service has gone from a slow-moving financial disaster to what is for a federal governmental entity a relatively efficient and profitable enterprise. By any standards, the Postal Service is also an enormous enterprise. If it were a private company, its $56 billion in 1996 revenue would have ranked it as the tenth largest in the country.

It has achieved this remarkable turnaround through strong leadership and a shifting of organizational attitudes. No longer is the Postal Service just another clumsy bureaucracy. Today, it is trying hard to emulate the cost-efficiencies and customer orientation of a private company.

As its organizational mentality has shifted to that of a private company, the Postal Service leadership has taken on many laudable private company attitudes. For example, the Postal Service seems much more aware of market dynamics and is much more focused on consumer satisfaction. One troublesome aspect of this new spirit, however, is an apparently growing desire to expand into new lines of business where private companies are already active.

The Postal Service seems much more aware of market dynamics and is much more focused on consumer satisfaction. One troublesome aspect of this new spirit, however, is an apparently growing desire to expand into new lines of business where private companies are already active.

This strategy by the Postal Service raises an important question for tax policy makers about the propriety of a governmental entity that competes with private companies. This question is all the more relevant since the Postal Service may be competing in these markets unfairly on the basis of special advantages it enjoys as a quasi-governmental enterprise. Chief among these special advantages is its tax-exempt status. As the Postal Service leverages its tax-exempt status and other special advantages, it poses a real threat to the success of competing, tax paying private companies.

The Postal Service is by no means the only quasi-governmental enterprise looking to branch out. The U.S. economy is sprinkled with organizations and industries that the federal government has granted special rules, including tax-exempt status. They run the gamut from credit unions providing retail financial services to power companies providing electricity.

Like the Postal Service, many of these organizations are using their special advantages to break into new markets and to compete with private companies. The profitability and indeed the continuation of many private companies are threatened as this expansionist trend among tax-exempt entities continues. The diversification of tax-exempt entities is made possible largely through an unintended and largely self-created tax loophole.

When these organizations were created and granted tax-exempt status, few people imagined that they would use their tax exemption as a competitive advantage in branching out into other activities. However, by expanding their activities, these organizations are effectively creating their own tax loopholes as the income from competitive activities also enjoys this tax-exempt status. These developments are a relatively new and important issue for tax policy. A related tax policy concern is the erosion of the tax base as non-taxpaying entities crowd out taxpaying companies. As tax-exempt entities play an ever-increasing role in the economy, their tax exemption will become one of the largest business tax loopholes in the federal income tax code.

The Postal Service Correcting a Market Failure

Over the years the U.S. government has established numerous special business entities to provide goods and services. For example, congressionally chartered corporations like Fannie Mae, Freddie Mac, and Ginnie Mae were established to provide liquidity in the home mortgage market, while Sallie Mae was established to provide liquidity in the student loan market. The Tennessee Valley Authority and the Bonneville Power Administration were established to encourage economic development in their regions fed by the provision of cheap electricity. Credit unions were established to provide retail financial services in poorly served markets. And, of course, the Postal Service was established to deliver mail.

The common justification for establishing these enterprises was the perceived failure of the private sector to meet a market need. A key tool for ensuring the economic viability of these entities was the granting of tax-exempt status. This status allows them to avoid federal income tax on their net incomes, if any, and it frequently allows them to escape other taxes such as local sales taxes on their purchases.

It is the nature of individuals who rise to the top of large organizations to want to defend the organization against encroachments and to expand and strengthen it.

In many cases, special regulations were also promulgated to ensure their success. For example, the Postal Service pays no dividends or return of invested capital to its owners, the taxpayers. Furthermore, the Congress has established that the Postal Service is not subject to the full enforcement powers of the Occupational Safety and Health Administration, it has the priority of the federal government with respect to the payment of debts from estates, and it may borrow directly from the U.S. Treasury or may issue debt to third parties backed by the full faith and credit of the federal government.

Perhaps the most important special provisions relating to the Postal Service are the Private Express Statutes granting the Service a monopoly over the delivery of letters. The Congress has also granted the Postal Service important legal powers to enforce its monopoly. While this monopoly is broad and comprehensive, there are five general exceptions to the statutory monopoly on letter mail: letters accompanying cargo, letters of the carrier, letters by private hands without compensation, letters by special messenger, and carriage of letters before or after mailing.

In addition, the Private Express Statutes provide an exception for "extremely urgent letters." To be able to deliver extremely urgent letters, the private firm must be able to meet strict time criteria for letters sent to within 50 miles of the intended destination and it must charge the greater of three dollars more than, or twice the applicable price of U.S. postage for First-Class Mail. This latter condition is the more prevalent and has the effect of setting a price floor for Postal Service competitors in the overnight delivery marketplace.

Through its tax-exempt status, monopoly powers, and other advantages, the Postal Service has developed an enormous work force and capital plant engaged in the delivery of mail. Like all large monopolies the Postal Service can use the resources developed in its monopoly market to reduce its costs in new markets. Specifically, it can use net income from its mail business to underwrite losses and otherwise compete unfairly with existing, for-profit businesses. Alternatively, it can cannibalize its labor and capital resources from its traditional businesses, thereby running losses in these businesses to subsidize and develop the new businesses. Such cross-subsidizations are common in business as the profits from one business unit are used to strengthen a weaker unit. The difference in the case of the Postal Service is that it can call upon advantages and resources unavailable to private companies to achieve these cross-subsidizations.

The Postal Service as Economic Policy

The central goal of economic policy is to ensure the country makes the best possible use of its resources. One element of economic policy is to ensure the proper functioning of free and open markets. This has often meant rooting out systemic market failures such as the development of monopolies. However, it can also mean the creation of business and regulatory entities, like the Postal Service and the Securities and Exchange Commission, respectively, when the private sector has failed to provide adequate service. Where the original need justifying the creation of an entity like the Postal Service persists, the entity's activities are themselves an element of economic policy.

As tax-exempt entities play an ever-increasing role in the economy, their tax exemption will become one of the largest business tax loopholes in the federal income tax code.

As a matter of economic policy, all government-created enterprises ought to be run as much as possible according to normal business principles. These enterprises were created to respond to a perceived market failure and should operate like a market participant. This can be difficult because, by definition, they are not always subject to the same market forces as a private company. For example, they may be subsidized by the taxpayer and protected by special regulations. They also are rarely subject to the same market tests of success or failure as a private company, such as offering a reasonable rate of return on investment. If they are granted monopoly status, then they are rarely subject to the pressures for greater efficiency and customer service that prevail for private companies. Therefore a government-created enterprise is unlikely to be as efficient as a private company.

If the nature of the original market failure has lessened or abated and the need for the organization has likewise sufficiently lessened or abated, then the entity's continued activities may cause a misdirection of resources. In this circumstance, the continued activities of the organization represent poor economic policy.

Alternatively, it may be sound economic policy for the Postal Service to continue to perform its basic function of delivering mail. However, if the Postal Service seeks to expand its activities into areas where it finds itself competing with private companies, then its tax-exempt status will inevitably give it a tremendous advantage. In the extreme case, if the Postal Service were truly to operate with the efficiencies of a private company, then its tax-exempt status would allow it to drive its taxpaying competitors from any market it so chose. In this case, the Postal Service would not need its tax-exempt status to compete. The effect of its tax advantage is ultimately to allow the Postal Service to extend its monopoly position to these new markets.

If, on the other hand, private companies are able to compete effectively with the Postal Service despite its advantageous tax status, then it necessarily follows that the Postal Service cannot be operating at the level of efficiency of a private company. The capital, labor, and energy resources consumed by the Postal Service in these additional activities are therefore less productive than they would be if they were released to the private sector. Such continued misuse of resources is clearly not sound economic policy.

The Postal Service in the Information Economy

Changes in the marketplace for the transmission of information are raising legitimate questions about the Postal Service's proper role in the economy. With the advance of the information age, the Postal Service is today at a crossroads. The transmission of documents and information plays a vital role in the economy. The worldwide web is unquestionably encroaching on the traditional turf of the Postal Service. E-mail is increasingly replacing both paper and the oral word as a means of quick communication. At the same time, invoicing and the payment of bills through direct electronic transfers are steadily advancing. Even the payment of tax bills over the internet is becoming commonplace.

The combination of a changing management philosophy and changing market conditions have led the Postal Service to enter new and competitive markets aggressively. It is human nature to defend, to build, and to improve. It is the particular nature of individuals who rise to the top of large organizations to want to defend the organization against encroachments and to expand and strengthen it. Given the institutional advantages of the Postal Service, such as low-cost financing and tax-exempt status, it would be counter-intuitive to expect the Postal Service's management not to enter whatever markets it could to subsidize its traditional operations, and to preserve its role in the economy and in society as a transmitter of communications.

The most obvious example of the Postal Service's branching out is its aggressive efforts in the parcel business, where it competes with a number of large, private companies such as Federal Express. In January of 1999 the Postal Service rolled out "Parcel Select". Under this service, businesses shipping more than 50 packages daily would receive "a cheaper price and equivalent or better service" than the private company United Parcel Service can provide according to David Shinnebarger, marketing and strategy manager for the Postal Service's Expedited/Package Services Group.

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A second example of the Postal Service's diversification efforts is that it now sells a prepaid phone card called the "FirstClass PhonecardTM." It can be ordered by phone or purchased at the local Post Office. It's rechargeable by phone by calling a 24-hour a day, seven days a week service. For an additional fee a customer can enroll in Voice and Fax Mailbox. The Post Office advertises that a 3-minute call from New York to Los Angeles during peak hours costs $1.00, while the same call made with a major credit card would cost $1.70. The proliferation of phone cards proves their customer appeal. With such cards widely available, however, it is not at all obvious why the Postal Service should be branching out into this clearly unrelated and heavily competitive line of business.

Entrepreneurial initiative is laudable. However, the Postal Service is branching out from its protected market of mail delivery, created due to a perceived market failure, into lines of business in which there is already stiff competition from private sector firms. The Postal Service repeatedly refers to its private sector competitors in the non-letter carrying business and claims that its pricing and marketing are largely determined by the marketplace. One of its key "Performance Goals" is to "use pricing as a competitive tool". Pricing, of course, can only be a competitive tool if the Postal Service is competing with private companies.

Expanding to Survive

According to its 1997 Annual Report, the Postal Service believes, "the correspondence and mail business will remain a dynamic market." Nevertheless, as it stated in its 1996 Annual Report:

> Sustaining the Postal Service mission as the universal service provider — offering a uniform service at fair and reasonable rates — requires a proactive vision of improving service, not standing passively and taking what private providers of service leave behind.
>
> A strategic component centered on *growing the growth business* [italics here and below are from the Annual Report] will focus on the rapidly expanding Priority Mail and package businesses, the growing advertising mail business and international mail. A *defend the core business* component focuses on the threat of new competition, both from traditional competitors and from the new electronic competitors that have been entering the market at an increasing rate, and the danger that threat poses to universal service.

More recently, Postmaster General William Henderson said in an interview, "We recognize that we are in head-to-head competition with the UPSs and FedExs of the world. Because our quality has dramatically improved, we are taking market share and volume from them, and they see us as a very big threat." [1]

This self-centered focus by the Postal Service is understandable and it would be perfectly appropriate if the Postal Service were a private company. But this focus is badly misplaced for a government-created, tax-exempt entity. The Postal Service's central concern ought to be that its customers are well served. If private companies can offer services as good as lower prices than the Postal Service can match, then it ought to greet these developments with satisfaction, knowing their customers are well-served, and it should leave those markets. If it is con-

[1] *Intersections* magazine, May/June 1999, published by PricewaterhouseCoopers LLP.

cerned about technological inroads into its core business, then it should strive for greater efficiencies in that business. If the delivery of mail is deemed to have a social as well as economic policy dimension, and if the Postal Service cannot perform this function satisfactorily without a subsidy, then that subsidy should be stated explicitly as part of the federal budget. No subsidy to the Postal Service should be hidden in net income earned at the expense of taxpaying private companies.

A Threat to the Tax Base

Another public policy issue is whether the expansion of tax-exempt entities like the Postal Service, and of special industry groups like the credit unions, are or may become threats to the national tax base. Clearly, if they are successful, then they will be drawing on resources that would otherwise be applied in the private, taxpaying sectors of the economy.

Like government itself, all tax-exempt entities draw resources such as capital, labor, and energy away from the taxpaying private sector. Presumably, these entities are granted tax-exempt status because they engage in activities that serve some public purpose. The American Red Cross and the Catholic Church are both examples of organizations the government has determined engage in activities that better society in some way. The Tax Foundation is itself a tax-exempt organization, having been granted this status because the Congress has determined that public policy research ought to be encouraged in a free society.

When tax-exempt organizations stray from their public purpose and engage in unrelated, for-profit activities, the resources employed are withdrawn from taxpaying employers and the tax base shrinks. The U.S. has long maintained that non-profit entities engaging in for-profit activities should be subject to tax. In 1950, the Unrelated Business Income Tax (UBIT) was levied to discourage non-profit entities from competing with taxpaying businesses and to prevent the non-profit entities from reaping an unfair advantage from their tax-exempt status. There are at least two clear motivations for the UBIT.

First, it is obviously unfair to the workers and shareholders of taxpaying companies to allow a non-taxpaying entity to compete in the same marketplace. Second, if the non-profit organizations are well managed, then they will be able to use the cost advantages afforded them by their tax-exempt status to dominate an ever-increasing share of the economy. This obviously poses a threat to the federal tax base as taxpaying businesses are crowded out by non-taxpaying entities. There is no tax comparable to the UBIT currently imposed on public-sector, non-profit entities like the Postal Service that engage in activities outside their original mandates. Consequently, these activities erode the tax base, causing other taxpayers to pay more tax than they otherwise would or reducing the total revenue of the federal government.

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Permitting the Postal Service to Compete, But Fairly

If Congress determines that the Postal Service ought to be allowed to expand into non-traditional lines of business, it should be required to alter its practices so as not to obtain an unfair market advantage. As a matter of sound economic and tax policy the Postal Service must not be allowed to use its traditional lines of business to subsidize forays into new lines of business. For example, if the Postal Service uses a facility for both its traditional and its non-traditional lines of business, then the non-traditional line of business must pay the full, pre-tax market price of its share of the facility. If one half of a distribution facility is used for traditional mail and one half is used for a new line of business, then the new line of business must pay the full, market rate for its half of the facility. This market rate must reflect the cost of utilities, the cost of the facility itself, and a reasonable pre-tax rate of return that would normally be charged to a tenant by a landlord.

Another change is that the Postal Service should be required to report its earnings on its non-traditional lines of business according to the procedures and rules under which for-profit companies operate. Having established proper and sound accounting practices on these new activities, it should then be possible to ensure that the physical and financial resources of the Postal Service's traditional activities are not diverted to subsidize activities that bring it into direct competition with existing, for-profit businesses. Similarly, it should be possible to ensure that these new activities, if profitable, do not provide an off-budget subsidy to the Postal Service's traditional mail delivery business.

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A third change is that the Postal Service's new lines of business should be subject to all the taxes of a for-profit business, including federal income tax on net income, if any. If each of these changes are made and if the Postal Service is able to compete effectively with for-profit businesses, then the Postal Service's traditional customers will be protected, its customers for its new lines-of-business will benefit from the heightened competition, and the national tax base will be protected.

Conclusion

The justification for a governmentally created national postal system is that of market failure. That is, it was presumed that the private market would not provide adequate and universal mail service in the absence of an enterprise like the United States Postal Service. Whether this justification held in the distant past is a matter for historians to decide. Clearly, however, with the rapid growth of private companies in virtually every area of related services from crosstown messenger services to overnight mail to parcel post, it is hard to argue that the private sector would not provide a full array of services on a cost-effective basis. As private firms in related markets demonstrate, there appear to be no effective barriers to entry in this industry. Thus the only reason private companies do not today compete directly with the Postal Service in the delivery of letters is because they are legally barred from doing so.

As a matter of economic policy, the Postal Service's strategic diversification and expansion plan is unjustifiable. This diversification diverts resources such as capital and labor away from more productive uses. The Postal Service's diversification also raises questions about whether it should be allowed to use its resources and its tax-exempt status to undercut private sector participants. The fundamental issue is whether it is fair for a government-created entity like the Postal Service to compete with private companies on the basis of its various special advantages, including tax-exempt status.

As the Postal Service and other similar entities exploit their tax-exempt status to expand their activities, they will increasingly crowd out private sector participants. The tax-exempt status applied to these activities constitutes a classic tax loophole. Further, as special, tax-exempt participants replace taxable businesses, the national tax base is sure to erode, thus creating pressures to raise taxes on the taxable businesses or individuals.

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