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Policy Study No. 82

Privatise the Post

steps towards a competitive service

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1
Introduction

The Government has taken large steps in order to improve the performance of the postal industry in Britain. These have involved splitting telecommunications from posts; injecting greater competition, actual and potential; developing an 'enlightened oversight' of the Post Office and rearranging the Post Office into four divisions, one of which (Girobank plc) is now a wholly-owned subsidiary. The Post Office has not, however, been an explicit candidate for privatisation although recent statements by the Secretary of State for Trade & Industry, the Chancellor of the Exchequer and the Prime Minister all contain hints that the Post Office may be on the list.

The Secretary's statement was in the form of a letter to the Post Office's Chairman, Sir Ronald Dearing (see Channon,1986) which contains, among other things, the words 'I shall want continually to consider the possibilities for introducing private capital into Post Office activities' (p.l7). Mr Lawson's hint came as part of his widely-reported statement at the Bournemouth Conference which foreshadowed a very ambitious programme of future privatisation plans. At least one newspaper interpreted this as including the Post Office. Most recently Mrs Thatcher has discussed the issue of privatisation during an interview with the *Financial Times* (19 October 1986). The interviewers summarised her attitude as follows – 'the only question is the order and the form'. In the light of these statements the Post Office certainly cannot be seen as exempt from any future privatisations.

If the Government moves in this direction it will be venturing into largely uncharted waters as all postal systems in the world are government-owned and to some extent monopolised. Nonetheless, there are good reasons for doing this. This paper sets out a proposed schedule for further liberalisation through gradual demonopolisation and privatisation of the Post Office, building on the already impressive achievements. This process could be accompanied by measures to protect the reasonable interests of rural dwellers. The programme envisaged would be complete in 1990.

We begin in chapter 2 by looking briefly at the history of the postal system in Britain from 1840 to 1979 and its dominant attributes of monopoly and government ownership. Until the 1980s the monopoly was virtually complete in that any major threats to it (such as the telegraph and the telephone in the late nineteenth century) had been incorporated into the single organisation. Postal services were generally profitable until the 1950s and became the subject of much controversy in the 1960s and 1970s. Limited steps taken in the sixties were insufficient to achieve an efficient and financially viable service. The debate continued in the 1970s, including the setting up of a Post Office Review Committee which reported in 1977.

During the 1970s the development of a courier industry and the gradual separation of telecommunications from postal services began to change the outlook markedly. While the then Government resisted these changes, the Thatcher administration did not. The British Telecommunications Act of 1981 resulted in the formation of British Telecom and the lowering of legislative barriers to entry. These important changes were followed by a complete restructuring of the Post Office and the development of a consultative type of regulation: this in turn has revolutionised the postal industry in Britain and set the scene for further, more radical changes in the next few years. This forms the theme of chapter 3.

Chapter 4 examines the recent performance of the Post Office. The quality, range and efficiency of its operations has unquestionably improved since reorganisation, and competition has increased during the last decade. This rather pleasing development could be taken even further if the Government proceeded with more organisational changes and further relaxation of restrictions on competition. Failure to continue the process of liberalisation and privatisation could result in the service ceasing to improve or even lapsing into its old ways.

Chapter 5 argues that an efficient, reliable and progressive postal service can be ensured by using market forces, and not by 'social control' which, in spite of various efforts in the past, has seldom proved itself efficacious. Social controls should be used only where market forces cannot function. In the case of postal services no genuine natural monopoly exists. There is, therefore, no significant place for social controls. This is not to say that the

'enlightened oversight' of the Post Office in recent years has not been successful.

The sixth chapter sets out the reasons and timetable for liberalising, reorganising and privatising British mail services over the period from 1987 until 1990, by which date the last change – sale of the Letters Division – would complete the metamorphosis to the world's first completely private and competitive postal system.

A seventh chapter discusses the difficult issue of cross-subsidies. If the Government wishes to see a competitive and private postal service while still retaining rural services at the current levels and rates, it may need to pay direct subsidies to providers of rural services or to levy a tax on urban users in order to create a fund for the supporting of rural services. Details of the cross-subsidy problem and possible solutions are set out in this chapter.

Coverage of various aspects of the Post Office's organisational and physical structure, and some of the background economics of public enterprise, natural monopoly, privatisation and cross-subsidies, is necessarily incomplete. A good account of the Post Office's history in the 1970s is contained in Corby (1979), and Daunton (1985) traces the history since 1840. The Reports of the Post Office Review Committee (1977) and the Monopolies and Mergers Commission (1984) also provide good background information. Annual Reports of the Post Office and the relevant legislation (the British Telecommunications Act 1981) are useful references.

Whilst the approach of the paper is largely non-technical and non-jargonistic – it is written for the non-economist as well as the economist with an interest in public issues – an understanding of the ideas of contestability and natural monopoly to the level of Baumol's (1983) readable survey would serve as a good background for those unfamiliar with these powerful ideas. Beesley and Littlechild (1983) is recommended as a good background piece on the economist's approach to the privatisation issue and the criterion of 'net consumer benefit'.

2

The history of the government postal monopoly in Britain until 1979

All postal systems in the world have the attributes of government ownership and legislated monopoly, at least in regard to standard mail delivery. Britain is no exception to this rule. Indeed, it was largely responsible for spreading this structure around the world. Even the United States has a similar system which 'developed as an offshoot of the British monopoly' (Haldi, 1985, p.4). Chodorov (1948) has rued and opined that 'if the [United States] Government had kept its hands out of mail business, the pioneers would have developed a mail service comparable to the telephone system, and the taxpayer would have saved uncountable deficit billions' (p.12). The Australian system also developed, in the colonial era, as an offshoot of the British Post Office and copied its organisational and legal stucture in all major respects (see Albon, 1985, ch.2).

In the distant past it was probably for reasons of security and revenue that governments developed state-owned monopolies in postal services. When these came under challenge from electronic means of communication in the middle and late nineteenth century, they tended to take over the new means of communication and incorporate them in the monopoly although, in North America, private monopoly telephone systems developed independently of the government-owned monopoly postal services.

In Britain the Post Office behaved in a typically monopolistic manner when confronted by the challenge of the telegraph and telephone. The telegraph was nationalised in 1869 and the telephone in 1912. As reported in an entertaining paper by a contemporary, Frederick Millar (1890), the British Post Office at first sought 'to take over the telephone', then 'to obstruct its introduction' (p.408) and finally succeeded in taking it over.

Ronald Coase, writing in 1961, showed how the Post Office jealously guarded its monopoly in his account of the rise and fall of messenger services in the latter half of the nineteenth century.

An exception to the monopoly allowed the despatch of a letter by a messenger 'on purpose' which gave rise to companies who employed messengers to deliver written communications. However, in 1869 the activity of a firm set up to exploit this loophole, the Circular Delivery Company, was determined to be illegal. It was held that the letters were actually being sent by the company, not by the individuals who wrote them.

Certain university colleges and student unions had also developed private posts. Under pressure these were disbanded except that of the Oxford Union Society. While the Post Office was preparing to act against the Oxford Union, the Boy Messengers Limited was set up by Richard King. The development of this and other companies was viewed with displeasure by the Post Office. A long political saga ensued as the organisation channelled much of its energy into protecting itself from competition. A number of factors, however, including technological change, in the end led to the demise of the messenger companies.

An interesting footnote to the story of the messenger companies was the debate in the correspondence columns of *The Times* between the famous Cambridge economist, Alfred Marshall, and an anonymous correspondent who claimed to write as a private citizen but turned out to be the Post Office Solicitor. Marshall, in a rare excursion into popular debate, strongly advocated a competitive postal system and ridiculed the shallow case for monopoly. In the course of this debate, Marshall made perhaps the first estimate of consumers' surplus loss as a result of monopoly – £4.5 million. This was calculated as the loss to consumers from the Post Office's ability to prevent the establishment of 'cheap and good' local services by private firms (see Coase, 1961 and Daunton, 1985, p.54).

In contemplating the history of the British postal industry in the nineteenth century, it is interesting that Rowland Hill, who is held responsible for the uniform 'penny post', was not, as it is often alleged, a supporter of cross-subsidy through a uniform price. Hill's advocacy of the penny post was originally confined to non-rural areas (i.e. his 'primary distribution' within and between post towns) and based on an estimate that the administrative costs of a multiple rate structure would outweigh its benefits in aligning rates more closely to costs. Outside of the

'primary distribution' Hill advocated higher charges unless services were subsidised by local authorities. Further, Hill was an 'ardent supporter of competition . . . not prepared to defend the Post Office's letter monopoly' (Daunton, 1985, p.54). Hill's views have almost universally been misrepresented (see e.g. Coase, 1939, for examples).

Postal services in Britain were profitable throughout the nineteenth century with the basic letter rate held at one penny in the face of falling cost levels. After telephones and telegraphs were taken under its wing, the Post Office developed as an overall government-owned and monopolistic organisation. Until the Second World War, posts tended to make profits which subsidised the loss-making telegraph and telephone services. However, being insulated from competitive pressures and bogged down in bureaucratic procedures, the organisation was poorly equipped to be an innovative, dynamic and cost-effective supplier of communications services. A 1932 Committee of Enquiry strongly supported maintaining the system of legislated monopoly powers in posts and telephones held together in the one government department. The Bridgeman Report's only major recommendation was the introduction of a different, more decentralised, management structure. Accepted by the Government, this recommendation determined the Post Office's internal organisational structure for the next thirty or so years.

After the war telephones became profitable while posts became a net burden on the Post Office. During the 1950s and 1960s the whole operation kept in the black only because of the seemingly insatiable demand for telephonic services. The postal side became a technically backward and unreliable service that made chronic losses from the mid-fifties to the mid-seventies. As Daunton notes (p.337), 'it would be remarkably easy to write an epilogue which gives a picture of postwar decline and inefficiency'. He, nonetheless, resists that temptation to some extent.

In 1964 an unusually dynamic and interested Postmaster General, Mr Anthony Wedgewood Benn, came to office and tried to do something about the postal system. Through his efforts a dual standard mail structure was introduced in 1968 with a higher rate for a faster, more expensive first-class mail service and a lower rate for a slower second-class service. This reform was

probably good both for users (as it made those content with a slower service better-off, and no one worse off) and for the Post Office (as it allowed the work-load to be evened out, particularly in mail sorting). Benn also realised that the Post Office would need to be taken out of the hands of the civil service if it were to become more commercial in its attitudes, and responsive to the demands of customers.

The changes made following the 1932 Bridgeman Report were a small step away from the civil service mode of operation. Then, in 1961, the Post Office was differentiated from other Departments in that it no longer received a vote of expenditure from Parliament. A Post Office Fund was created into which all revenue flowed and from which all expenditures came. At the same time the Post Office became subject to financial targets but was not made a nationalised industry (see Daunton, pp.343-4).

Complete separation from the civil service occurred in 1969 with the Post Office Act under which the British Post Office became a public corporation, still operating both mail and telecommunication services. While no longer a government department, the Post Office remained under the jurisdiction of a department — initially the Ministry of Posts and Telecommunications and later Industry (now Trade and Industry). The establishment of a public corporation was a further move intended to make the postal service more business-oriented while still being government-owned. The change was accompanied by the formal establishment of a watchdog organisation – POUNC (Post Office Users' National Council) which was supposed to make the postal and telephone services more responsive to users' demands. An ambitious plan to mechanise all mail-sorting over six years was also commenced in 1969.

Built into the financial structure of the new corporation was the necessity of covering the costs of operations from its own revenues. But it was given several advantages. Not the least of these was continued protection from competition. The new corporation inherited the letter monopoly from the old Postmaster General's Department (although the 'letter' remained ill-defined). Pricing was supposed to be cost-related and sufficient to cover costs overall. Otherwise the corporation was not subject to ministerial oversight in this regard. Ministerial

interference in day-to-day operations was also removed under the new system.

In 1970 Ian Senior's 'The Postal Service: Competition or Monopoly?', published by the Institute of Economic Affairs, called for the complete removal of the letter monopoly. The strike by postmen in the following year answered the call. The Post Office, with the co-operation of the Minister, used powers available to it under the Post Office Act to grant licences to private postal operators to carry letters for reward for the duration of the strike. This important power to remove the monopoly was contained in the 1969 Act (and formerly available, with some differences, under the 1953 Post Office Act) which could, in fact, be used at any time to remove completely the Post Office monopoly by the stroke of a pen. The 1981 Act transferred this power to the Minister.

Parcels and international mail had always been open to competition. However, a new area of competition opened up in the 1970s. This was the beginning of a courier industry in 1972. A loophole in the law (in fact, the 'messenger on purpose' one) was exploited by an entrepreneur who set up the 'Post-Haste' courier company in London. This venture, like those a century earlier, was threatened by the Post Office and, partly as a result, was not successful. However, other companies entered the industry providing time-sensitive delivery services. A significant sub-industry of couriers using individual pick-ups from customers rather than centralised (post box) collections emerged. In spite of its dubious legality, this fringe industry developed during the decade and began to bite at the edges of the official monopoly.

It is of some interest that the British Post Office commenced its own courier operation (Expresspost) in 1976, thus providing another of a long list of examples of private entrepreneurs leading the way in the development of new postal services. The legal status of the private courier industry was finally clarified in 1981 in the British Telecommunications Act.

Table 1 overleaf shows the profitability of the Post Office in total and by service since the mid-1970s. The year 1976-77 saw the postal services side becoming profitable after many years of losses. This return to profitability came about primarily because the letters side greatly improved consequent on the lifting of a price freeze in 1975 (and an 80 per cent jump in tariffs) – and the

TABLE 1
POSTAL SERVICES PROFIT AND LOSS BY SERVICE, 1974-75 TO 1985-86 £m

	YEAR											
SERVICE	74-75	75-76	76-77	77-78	78-79	79-80	80-81	81-82	82-83	83-84	84-85	85-86*
Inland letters	(65.3)	20.0	26.4	21.3	14.1	16.8	18.5	55.8	79.0	50.7	86.9	94.4
Parcels	(44.8)	(42.8)	(18.0)	(7.7)	1.9	1.1	(5.2)	7.1	13.2	19.2	7.6	16.0
Overseas	(2.3)	7.9	5.6	8.9	6.9	0.2	1.5	10.0	24.8	32.6	35.6	—
Counters	3.2	5.7	10.3	17.9	10.2	16.0	12.3	16.1	11.5	13.9	2.9	26.4
Others								(1.0)	1.6	0.5	0.7	
TOTAL	(109.2)	(9.2)	24.3	40.4	33.1	34.1	27.1	88.0	131.6	116.9	133.7	136.8

SOURCE: *Post Office Reports and Accounts, various issues*

* From 1985-86 the Letters Division handles all letters and the Parcels Division handles all parcels – no separate account for overseas mail.

effects of such economies as abolishing Sunday collections in May 1976. Parcels (which made such losses that they were nearly abandoned by the Post Office (see Corby, 1979, p.225)) had also shown an improvement. After gradually falling losses, they became profitable in 1978-79.

The 1977 Report of the Post Office Review Committee (the Carter Committee), can hardly be described as a radical manifesto, and was, if anything, an obstacle to rational change. The Report, while critical of aspects of the Post Office's activities (unresponsiveness to customers and poor productivity), called for strengthening of the monopoly and the prosecution of offenders. It failed to perceive the opportunities for improved services which were being opened up by the advent of competition. It argued that the 'postal monopoly allows the existence of a universal system which is in the public interest, and it is not to the general advantage to allow the "creaming off" of selected profitable traffic, as has occurred in Australia . . .' (p.71). The Committee did, among other things, advocate separating telecommunications from postal services, a recommendation which was rejected by the then Government (see Secretary of State for Industry, White Paper 1978).

3
Major changes in the 1980s

The new Government took a different approach from that of its predecessor and carried out its own review of Government involvement in the communications industry. Sir Keith Joseph ordered a significant enquiry into the postal monopoly. Many changes, including the separation of posts and telecommunications, the introduction of more competition and the complete reorganisation of the Post Office have occurred under the present Government.

Throughout the 1970s the postal and telecommunications sides of the Post Office's operations had been progressively split at all levels and this process was completed in 1981 with the British Telecommunications Act. This Act created British Telecom as a completely separate entity, a step which was important for a number of reasons – it set the scene for the liberalisation of telecommunications and the privatisation of Telecom; removed for good any question of internal cross-subsidies from telecommunications to postal services; gave the postal services a separate identity and independence; and created the possibility of competition between Telecom and Post at the fringes (especially electronic mail).

The 1981 Act gave the Minister the power to grant licences 'either unconditionally or subject to any conditions specified' to allow operation of services normally covered by the Post Office's exclusive privilege. This power was used, in November 1981, to allow the legal carriage of time-sensitive mail subject to a minimum charge of £l and the carriage of Christmas cards by charitable organisations until the year 2007. In 1982 the private document exchange system was given legal power to operate.

While there are no published figures available, the rise of the private courier industry has been an obvious success. It is clear from British and overseas experience that if there is any 'natural monopoly' in the postal system it does not extend beyond the standard mail area. Fringe operators have been able to duplicate the activities of collection, sorting and delivery of parcels and time-sensitive mail at competitive prices – which is remarkable in view of the advantages possessed by the existing

official systems in regard to costs (e.g. non-liability for taxes in Australia), joint use of facilities and ability to cross-subsidise from monopolised areas. Yet these systems have been unable to crush rivals. In fact, the contrary has occurred.

A major reason has been the spur to cost-savings as a consequence of competition. In the case of one national parcel operator, Interlink (see Rawsthorn, 1986), the key to success has been the centralisation of sorting and administrative work at a hub near Bristol, and the use of a franchising system for the local delivery and collection of parcels. Franchisees are paid on a commission basis. Interlink has, by these initiatives, been able to develop a national network with a small capital outlay.

In addition to granting the licensing power, the Act also allows the Industry Secretary the power to 'suspend the exclusive privilege conferred on the Post Office by section 66(1) for such a period and to such extent as may be specified in the order' (section 68). This is an important clarification of a power which has its origins in the 1953 Act and was further developed in the 1969 legislation. The Minister could, without legislating, completely demonopolise the British postal industry. The importance of the 1981 Act is difficult to over-estimate in that it makes postal services potentially very competitive; far more so, in fact, than telecommunications.

Apart from the rise of the couriers, the other area of competition opened up is that of 'electronic mail'. This is where a communication ends up in written form but involves some transmission via electronic means (e.g. a telex or a fax). Electronic means of communicating letters are explicitly excluded from the Post Office's domain of exclusive privilege. The Post Office has established two electronic mail services in the 1980s; firstly, an international and domestic person-to-person facsimile service, Intelpost, in 1980; and a computer based laser-printing service for bulk mailings, Electronic Post, in 1981. While these services must use British Telecom lines (and those of overseas telecommunications carriers), an element of competition is nevertheless established. The Post Office, with its unrivalled network of post office counters, is in an excellent position to offer an electronic mail service to those without their own fax machines by means of with a link-in with its mail and courier services. The Post Office does not release figures on the financial performance

of its electronic mail services, claiming commercial confidentiality. However, Intelpost obviously makes a loss. The 1984-85 Annual Report had, as one of its objectives, an increase in Intelpost traffic of '100% in 1985-86 leading to break-even by 1987'. (It is understood that this objective has not been fulfilled.)

Ian Senior argued in his 1983 Research Monograph that the electronic mail area – including electronic funds transfer – will gradually eat into the market for traditional mail so that the maintenance of exclusive rights on letters will become less relevant. An extension of the Post Office's monopoly seems highly unlikely. Opinions vary on its future, but no-one doubts that electronic mail is destined to become a major part of the communications industry. However, this does not necessarily mean that traditional mail reaps no advantages from the new technology – for example, the widespread use of credit cards has led to more and more ordinary mail being used for the sending of accounts. Further, new word processing technology has reduced the cost of producing letters and may have increased their usage.

The role of British Telecom in the electronic mail industry is very important. Apart from the as yet minor competition from Mercury, British Telecom still has the monopoly in the transmission and switching of electronic signals and, therefore, has the capacity to undermine competition in the electronic segment of the mail industry unless prevented from doing so.

It is vitally important that the electronic mail sub-industry in Britain is allowed to develop on a level playing-field. As Mercury develops as an alternative carrier, then, provided that it does not enter into tacit collusion with British Telecom, the need for explicit regulation to ensure fair play will diminish or disappear. Other technological developments – such as the growth of satellite communications – will assist in the enhancement of the industry in terms of the range, quality and price of the services offered.

Apart from the changes already discussed, the Government has set about reorganising the Post Office and developing a system of arms-length regulation of its activities. Aspects of the regulatory structure are discussed in the next two chapters and in Albon (1986b). Here we set out the elements of the current reorganisation of the Post Office.

The Post Office, after the departure of telecommunications,

was divided into two broad divisions – Royal Mail and Girobank. The Government has since approved a further split into four divisions (see Appendix) by reorganising Royal Mail into three parts – letters, parcels and counters. And Girobank has been converted into a plc, an obvious step towards privatisation. The Secretary of State for Trade and Industry (see Channon, 1986, p.17) has urged the Post Office Board 'to press ahead with the incorporation of the counters business as a subsidiary company' and 'to consider further application of this principle'. If all sections become plc's it will set the scene for privatisation by parts (beginning with the banking division) as set out in chapter 6. Apart from its importance in a sequence of moves towards an ultimate goal, the divisional split will have the additional benefits of removing the possibility of cross-subsidies between areas (except, perhaps, through allocations of joint costs), of generating some competition between divisions and of giving each area a sense of identity.

The 1980s have also seen some initiatives from within the Post Office aimed at reducing costs and improving services. In 1980 there was a productivity agreement with unions that has had only limited success. After many years of failing to achieve a mechanisation programme involving semi-automatic sorting (commenced in 1969 and supposed to be complete within six years) the Post Office has at last completed this programme and announced a new initiative involving sophisticated optical character recognition equipment which promises substantial (but not huge – see Monopolies and Mergers Commission, 1984) labour savings. Automation of counter services in Crown post offices on which there are plans to spend a total of £250m. over the next five years, was announced in 1983 and has been recently re-affirmed. Mail transport has also been rationalised with considerable cost-savings claimed.

All these changes and initiatives have placed the British Post Office amongst the world's top performing postal administrations with a high quality of service, high profits and low rates of charges. On the basis of his 1983 review, Ian Senior (1983, p.14) concluded that 'the British postal system is one of the best'. This commendable performance is described in the next chapter.

4
Performance

During the last decade, the Post Office has found itself in a more competitive environment, separated from telecommunications and under threat of further breaking-up, demonopolisation and privatisation. Faced with these facts of life the organisation has had to improve its performance and postal users have reaped the benefits. It has broadened its range of services, maintained its quality of service, reduced its real unit costs, kept its charges in line with or below those prevailing overseas, and made a very handsome profit. Nonetheless, as we will see, problems still remain, even after these improvements.

As was noted in the previous section, the Post Office made considerable improvements in the range of services it offered in the late 1970s and early 1980s. In both cases the new services were, at least in part, inspired by the pressures of competition. The new courier service, 'Expresspost', was a response to private couriers while the electronic mail services partly resulted from the separation of telecommunications which was formalised in 1981. According to S. C. Littlechild (1983b) the 1981 British Telecommunications Act, 'had the immediate effect of promoting rivalry between the two businesses in borderline areas such as electronic mail, with consequent improvements in services and prices' (p.116).

The 'quality' of the British basic mail service has always been high in one sense. It has been, for nearly 150 years, comprehensive, covering all inhabitants at a uniform price. Deliveries have been frequent – eleven per week in urban areas – and convenient – delivery is usually made into the house or flat, and not to an external box. Post offices (including the subs) are plentiful on a per-capita basis by international standards, although many have restricted opening hours and archaic paper-based methods, sometimes leading to the existence of long queues at many counters. Mail collections, however, are not an outstanding success of the system, especially since Sunday collections ceased in 1976.

Another dimension of 'quality' is reliability, and here the British system has also performed rather well. The major threat to

reliability is that of union action: strikes and work bans which disrupt the flow of mail. Given that the state retains exclusive trading powers, such disruptions are crucial – unions are given an element of derived monopoly power. This problem has been handled in the United States by making postal work a no-strike occupation. In Britain it has been largely solved by giving the Minister the power to suspend the monopoly during industrial disputes. This has proved a powerful weapon in the maintenance of a reliable postal service, in spite of absence of actual competition for standard mail.

Reliability is usually measured by the 'percentage attainment' of published delivery standards for both classes of mail. POUNC is particularly fond of these measures and has been critical of both the degree of attainment on certain routes and the point of measurement. Although there are problems in this regard – and although POUNC should be applauded for its vigilance – the performance of the Post Office by this measurement is satisfactory and it is doubtful whether the benefits of a major improvement would justify the costs.

Another, and perhaps the most important, indicator of performance is the price at which services are provided. Services must, of course, be quality-adjusted but the main problem arises because, with the lack of an appropriate yardstick, it is extremely difficult to evaluate the performance of government-owned bodies with monopoly power.

Domestic comparisons for the basic mail service are not possible as private competition is not allowed. In certain areas – some 'letters', time-sensitive mail, parcels, electronic mail, and international mail – private and/or public sector rivalry now exists but comparisons are still shaky since detailed information is lacking from both the Post Office and its rivals.

International comparisons are problematic because of difficulties with currency conversions through exchange rate controls and fluctuations, different financial arrangements relating to the various postal services and different geographical conditions. It also must be remembered that the comparison is between government-owned monopolies and not between government monopoly and a private competitive operator. Nonetheless, comparing different countries' systems is of some interest.

The use of international comparisons was strongly recommended by the Post Office Review Committee in 1977 which produced its own comparison of basic postal rates using exchange rate data to convert into pence. Table 2 opposite presents their data as of November 1976. Britain does very well in this comparison, being the cheapest of the unsubsidised or deficit-free countries. The Carter Committee does, however, warn of the pitfalls of using exchange rates for making conversions.

The Post Office took up the suggestion of making international comparisons, which feature in several of its reports. A 1983 comparison of several countries was produced by the Post Office and reproduced in Senior (1983, p.13). It showed the price of a letter in pence adjusted for cost of living, the actual loss or subsidy to the postal administration and the number of post offices per 20,000 of population. Of the ten countries covered, only four had lower rates than Britain, but all of these had losses or subsidies (Britain being the only country of the ten to show a profit) and most had much lower ratios of post offices to population (only Ireland of the ten had a higher ratio than Britain). March 1984 and April 1986 tabulations by the Post Office are also shown in Table 2 and again Britain comes out well.

The Post Office has also been successful in keeping the rate of increase of its tariffs below the rate of inflation over the last decade. The tariff index adjusted for inflation stood at 100 in 1977 and was 90.5 in 1986, prior to the rate increases in October, (which will have only a minor effect on the index). This performance means that the Post Office, partly at the instigation of the Government which sets targets for cost reductions, is passing on the reductions in real unit costs which it has been achieving.

It must also be kept in mind that Britain's postal service returns a very handsome profit (see Table 1) – in 1985-86 it was £136.8 million or nearly 5 per cent of turnover – and contributes heavily to Government coffers (£70 million in 1985-86). Very few other postal administrations make consistent profits or run without subsidies of some kind, and while profitability is by no means the only criterion of performance, it is significant that the British system provides a good service, at relatively low prices, and makes a good profit.

TABLE 2
POSTAGE RATES BY COUNTRY, NOVEMBER 1976 MARCH 1984 AND SEPTEMBER 1986

COUNTRY	NOVEMBER 1976	MARCH 1984	APRIL 1986
Canada*	6.2	17.2	
United States*	7.9	12.0	
United Kingdom	8.5	16.0	17.0
Eire	9.0	21.6	23.0
Denmark	9.2	16.7	17.5
Luxembourg	9.9	17.0	21.1
Japan	10.1	—	—
Belgium	10.7	18.1	19.8
Italy*	11.9	21.1	27.1
France	12.2	18.1	19.7
Germany*	12.7	20.3	21.7
Netherlands	13.3	17.2	18.2
Australia*	13.6	19.7	15.9

SOURCES: Post Office Review Committee (1977, p.5), for November 1976, British Post Annual Report 1983-84 for March 1984 (except Australia and Canada) and Post Office Report for 1985-86 for EEC countries.

NOTES: (1) * Denotes subsidies or deficits are common.
(2) Figures for 1984 are 'corrected for cost of living', except those for Canada and Australia.

To be weighed against this rather rosy picture some other negative considerations need to be taken into account when assessing the performance of the Post Office. It must be remembered that the British system looks good only when compared with government-owned monopolies in other countries – and when compared with itself not all that long ago.

Two types of inefficiency can be defined, often co-existing. The first type, call it cost-inefficiency, is where a given level of output is produced at a cost above the minimum possible, given the available technology and competitive input prices. The second category, allocative inefficiency, is where prices diverge

from long-run marginal production costs other than in the 'Ramsey' manner*, and/or where justified by 'administrative costs'. Both types of inefficiency can, to some extent, be observed in the British Post Office.

Consider first cost-inefficiency. Evidence of this comes from the Monopolies and Mergers Commission Report (1984) which found a 'fundamental deficiency . . . in the Post Office's management and control systems' (p.6) and was critical of the degree of efficiency in mail sorting. The Commission studied four District Offices and estimated that if the other three of the four District Offices were 'brought up to the present level of efficiency of [the best of these] Belfast, the Post Office would save between £2 and £4 million a year' (p.7). This saving would be much larger on a national basis. 'Unless the Post Office can . . . establish and operate modern management methods it will be unable to match the competition from the other forms of communication which it recognises it will face in the years ahead' (p.7). The Commission also found problems with sorting and noted the potential for significant cost savings through further reorganisation, mechanisation and automation. In short, some cost-inefficiency still obtains in the postal system.

The Carter Committee had earlier made a number of criticisms of the Post Office's efficiency, not all of which have been properly met. Like the Monopolies and Mergers Commission, the Post Office Review Committee criticised management structure and the sorting area. It also made further comments on such matters as the possible inadequacy of delivery arrangements (another area where significant economies are possible).

Secondly, consider allocative inefficiency. While the pricing of parcels, international mail and time-sensitive mail might be expected to conform reasonably closely with sound economic principle because they are competitive, this is probably not true of

* Efficient 'marginal cost pricing' involves setting a price (the value to consumers of the last unit purchased) approximating to the addition to total cost of producing it. However, where joint or common costs are present, these must be spread over the various services in such a way that there is the least possible disturbance of that resource allocation which would occur under marginal cost pricing. This entails setting relatively higher prices for those services which have consumer demands least responsive to their prices. Prices which are designed to cover total costs with the least misallocation of resources are known as 'Ramsey prices'.

inland letters. However, it is true that weight is a factor, that some bulk-mailings are discounted and that the first-and second-class distinction incorporates an allowance for different sorting costs. There is, however, no evidence of consistent use of the 'Ramsey' principle as in the United States where its Postal Rates Commission once used it explicitly, and now appears to apply it implicitly except for the politically sensitive first-class mail (see Scott, 1986).

Pricing of parcels and international mail is related to distance but only in a very crude manner. In the case of parcels there is an area rate and a national rate, but the difference has been insufficient to prevent competitors from taking much of the short-distance market. Significantly, the 1985-86 Annual Report contains an action plan to 'develop a new pricing structure to reflect changing market conditions' (p.18). Probably this will also involve a movement towards more efficient pricing; and the separation of Parcels from the rest of the Post Office should ensure that no internal cross-subsidisation occurs.

If we look at the pricing structure of inland letters in a geographical context it is clear that there are major differences of costs of different mail categories (e.g. intra-metropolitan is much cheaper than intra-rural) not reflected in prices, which are, of course, uniform across the country. This could result in quite significant efficiency costs as some users are induced to over-use the system while others are discouraged unnecessarily.

The 'penny post' was a compromise that, in the 1840s, appeared reasonable when all relevant considerations were taken into account. This may no longer be the case and, if efficiency gains exceed administrative costs, the Post Office should move to a multiple (probably two-) tier rate structure – that is if efficiency is a prime objective. Hill's original plan was for just such a system with the penny rate confined to traffic within and between postal towns and other services subject to a surcharge, or subsidised by local authorities. This issue is discussed in detail in Albon (1986c).

Of course, we are now near to the point where the Post Office's 'community obligations' require discussion. This is, however, deferred until chapter 7. Before doing this we must examine the limitations of social control and the alternative ways which have been suggested in order to make the Post Office more efficient.

5

The limitations of social control

For future policy on the postal industry there are two broad alternatives to the present mix of social and market controls. It does not seem, in the light of past trends, that the direction will be towards more non-market regulation. Indeed, we argue strongly in this chapter that a change of direction away from greater laissez-faire would be unconducive to further improvement. Social controls are an inadequate substitute for market forces even if they have to be adopted in cases of 'natural monopoly', or in order to achieve particular objectives.

The case for competition and against bureaucratic controls has been well-made elsewhere. Beesley and Littlechild (1983) is a sample of the former, and Littlechild (1983a) of the latter. Nonetheless it is worth summarising the arguments here as a background to the discussion in the next chapter.

The point should first be made that some will argue that postal services is an industry where 'natural monopoly' is not significant, even in the standard letter service, and social controls are, to a large extent, not necessary. In short, it is contended that market forces can be given free rein. This does not appear to be the case – yet – in telecommunications where the local exchange network has elements of natural monopoly and something like OFTEL is necessary to control 'competition' so as to prevent British Telecom from exploiting its natural monopoly power. In traditional postal services there is no obvious analogue to the local exchange – that is, there is no naturally monopolistic element that would temper one's enthusiasm for unleashing market forces completely. The 'natural monopoly' question is discussed at length in the next chapter.

Competition is itself an important disciplinary force absent in statutory monopoly situations. It is instructive to note that it is in the fringe areas where competition is allowed that government monopolies tend to perform best. In the case of the Post Office there is competition in parcels, time-sensitive mail, counters (except on government agency work), international mail and electronic mail, as well as an ever-present threat of total demonopolisation which is helping to keep the letters area at

heel. Historically, private firms have shown the government-owned postal services the way in improving services.

Private ownership is also important for various reasons. Perhaps most important is that it encourages the development of a strong relationship between reward and effort at all levels of the organisation. While ownership and control are still separated in a large privately-owned enterprise, there is a closer nexus than in an organisation where everyone (in fact, of course, no one) owns it.

A further advantage of private ownership is that a privately-owned business can be taken over if the management is not performing well. That is, the 'market for corporate control' can act as a disciplinary force on management. This discipline is absent in government-owned corporations.

Governments attempt to substitute for the discipline of market forces and identifiable ownership in various ways. The usual procedure is to lay down a set of requirements about such things as overall returns (setting of financial targets), discount rates to be used in making investment decisions, procedures for procurement, and pricing (usually according to long-run marginal cost)*. Concepts of economic efficiency lie behind the various requirements specified but there are at least three fundamental problems with this approach:

- Public sector managers lack incentive to implement these requirements since they are unlikely to share in the rewards of their efforts. Indeed, to do so very often conflicts with their own self-interest in regard to the organisation. Individual interest and economic efficiency may well not coincide. Open procurement procedures might, for example, threaten a cosy relationship with equipment suppliers.
- Where requirements are not met, excuses will abound and, generally, the Government will be powerless to do much about it. Apart from heavy-handed intervention (which can easily back-fire) the Government cannot punish poor performance except by threatening exposure to competition (marketisation) and/or privatisation.
- The requirements specified will often be internally contradictory (see Brech 1985). Achievement of one (e.g.

* See Brech (1985) for a discussion of the controls used in the United Kingdom.

pricing at long-run marginal cost when costs fall with output) will often be inconsistent with another (e.g. achieving a particular financial rate of return). So even with the best will, the attempts to make government-owned monopolies run efficiently may founder.

This is not to say that an unregulated privately-owned firm in a competitive environment will necessarily operate in an allocatively efficient manner, although cost-efficiency can be expected. There are some circumstances where completely open competition will be undesirable, others where regulation of some kind will be required to prevent exploitation of monopoly power. What is being argued is that market forces should be used to the greatest possible extent and social control only as a last resort. Opinions will of course diverge as to where that dividing line lies.

In the case of the Post Office the Government has used a combination of measures to attain a not unsatisfactory outcome. Probably most important is the use of actual and potential competition and the hint of privatisation. This has been combined with sensible reorganisation; of which the new divisional split is a recent example. Finally there has been a degree of social control in the form of enlighted oversight. This 'regulation', discussed more fully in Albon (1986b), involves setting of financial and performance targets as well as guidance on pricing policies. It does not involve heavy-handed controls on what prices are charged, what investments are made, etc. The Monopolies and Mergers Commission also investigates certain aspects of the Post Office's operations.

6
The timetable towards a private competitive postal system

The threat of demonopolisation has been hanging, like the sword of Damocles, over the British Post Office and has, when combined with other changes, sparked a dramatic turnabout in the efficiency of its operations. In the longer-term this may not be enough to maintain the dynamism currently observed. Further competitive pressures should be applied and this section contains a timetable for the achievement of a completely competitive and private postal system in Britain. The timetable set out is, to some extent, a natural extension of the changes that have occurred since 1981, although these changes do have a logic of their own.

Greater competition (1987)

Although the exceptions to exclusive privilege already allowed have been most successful in fostering the development of a private postal industry, the £1 minimum has been too high to encourage the development of a standard mail style of operation. The closest service to that of basic mail was proposed by Postplan (see 'London Standard', 2 April 1986). This would offer a £1.50 service for items up to 500 grams with same day delivery for morning collections and overnight delivery for evening ones. With a charge of 50p for proof of delivery and insurance, this scheme offers a price of about half of that of existing couriers. (But compare with Post Office charges of 18p for up to 60 grams and 92p for 500 grams.)

Localised collection and delivery companies would probably be encouraged to enter the industry if the minimum price were lowered, perhaps to 50p. These companies would perhaps concentrate on the business sector and interconnect with one another for collections and deliveries outside their local areas. In fact, local delivery companies were able to offer services at half the price of the Post Office over 100 years ago. Development of this sort would have to await full demonopolisation. But a lowering of the minimum to 50p would certainly be a big step in this direction. The Secretary of State for Trade and Industry has the power to make this change under the British Telecommunications Act.

Complete legal separation (1987)
The internal reorganisation of the Post Office, due for completion in 1987, has stopped short of making the separate businesses plc's, except in the case of Girobank. This step should be taken for the three remaining divisions – counters, parcels and letters. The opportunity should also be taken to enact the enabling legislation for the privatisation of the four divisions of the Post Office.

Developing electronic mail (1987)
The electronic mail sub-industry is not developing as quickly as was predicted some years ago. Volumes of conventional mail are rising rapidly (5.9 per cent in 1985-86) but the Post Office's electronic mail services are not doing well. The letters division can only bring itself to report an unenthusiastic 'presence' in this area as the last item in its list of achievements (Post Office Report, 1985-86, p.29). In an effort to revitalise this area, the responsibility for electronic mail should be taken from letters plc and placed in counters plc. This would be consistent with both the present automation of counters and the promotion of competition between the divisions. Consideration should also be given to investigating whether British Telecom has played any part in the retardation of the electronic mail sub-industry. Perhaps the Office of Telecommunications could be asked to look into Telecom's charging policies for use of its network?

Privatisation of National Girobank (1987)
The post office bank – Girobank – was converted to a public limited company in 1985, an important transitional phase towards privatisation which should take place in 1987. There is no sustainable economic argument for the Post Office retaining ownership of Girobank. Of course it is important to get maximum usage from the Post Office's national counter services network. But this is consistent with privatisation of Girobank. The fact that post office counters can be vehicles of banking business does not imply that the owners of the counters should own the bank. On the contrary, there are advantages in separating ownership, as there also are in allowing other financial institutions access to the counter network.

The other advantages expected from private ownership – a stronger link between reward and effort, greater control by owners through identifiability of interest, ability of the organisation to be taken over if it is under-performing, etc. – should also derive from full privatisation of Girobank.

Privatisation of Counter Services (1988)
The provision of postal counter services is already partly privatised in that much of its work is done by private business people acting as sub-postmasters. The division of the Post Office that operates the network of Crown post offices and engages sub-postmasters should be privatised entirely in 1988, after incorporation as a subsidiary company in 1987. Privatisation would facilitate the most efficient possible usage of the existing counter network, and encourage the taking on of non-postal business over the counters. As the operator of the electronic mail services the counter company could provide some competition for the letters and parcels divisions as well as for British Telecom.

Two significant problems, however, have to be solved before counters can be satisfactorily privatised. The first concerns the future of the *de facto* (but not statutory) monopoly which the Post Office at present enjoys in the handling of certain government business; the second concerns the future of the rural sub-postmasters.

The author believes that it would be a mistake to privatise counters while the monopoly on government agency work was effectively intact. Of course, to sell with exclusive franchises would enhance the proceeds of the sale but economic efficiency would remain impaired. A possible compromise would be gradually to introduce open tendering for government agency work, so that the monopoly would be ended completely in, say, five years. Meanwhile it must be ensured that the present programme of automating counters be technically consistent with the provision of agency services of all types, including banking. Further, the new Post Office counters plc should be subject to no legal restrictions on the agency work it takes on.

The question of sub-postmasters must also be considered when privatising counters. The subs are a very important part of the postal network. As a private enclave within the postal system, they demonstrate nicely the advantages of *both* privatisation *and* competition. There are 19,500 of them (out of a total of 21,000 post offices, 1,500 of which are Crown post offices).

The sub-offices are operated by full- or part-time sub post-masters; and staff employed by them are not employees of the Post Office. Their agency work is often combined with another business undertaking (e.g. a newsagency). Most of them are in rural areas. But many are in urban ones where they provide competition for Crown offices, and tend to perform better then them. This superior performance was highlighted by the Carter Committee who had 'no doubt that the scale payment offices . . . are significantly more economical' (p.87). This is probably a consequence of a closer nexus between reward and effort fostered by private ownership, and of a system of remuneration whereby payment above a minimum level varies directly with the number of units of work performed.

The Carter Committee strongly supported the sub-office system, and advocated greater use of part-time sub-postmasters. The Post Office Union has been less enthusiastic, probably because of the competition provided, and the evidence that private post offices perform better than Crown ones. It preferred the concentration of counter work in urban areas in Crown offices (see Corby, 1979, p.45).

As alternative postal operators began to develop there would be alternative opportunities for these postal entrepreneurs. Some would want to take on the agency work for other postal companies. Liberalisation of the postal system could well result in expanded opportunities for the sub-postmaster.

Complete removal of statutory monopoly on letters (1988)

This is the major step in the process of liberalisation which, if taken, would separate Britain from all other countries which maintain some element of legislated monopoly over at least some definition of 'standard mail'. It should be remembered that this step could be taken by ministerial fiat.

The monopoly was originally taken by the state for reasons of security (protection of confidential, politically sensitive and strategically important material). It came to be used as a means of raising revenue through the abnormal profits which the State's coercive powers, acting on its behalf, made possible. Later the monopolised mail system was also used as a means of delivering political favours through cross-subsidies – certain groups were given access to the service at a price below its cost of provision to

them, the loss being made up by profits reaped from those not so favoured.

Of course the postal monopoly has been justified on grounds other than that of serving the selfish interests of politicians and of those who operate the system. One argument has been that the postal system is a 'natural monopoly' in that the lowest-cost way of getting the job done is through a single operator. The second justification, popular with the operators of the service and those who sympathise with them (e.g. the Carter Committee) is an appeal to the community obligations (to cross-subsidise) imposed upon them. Those who assert natural monopoly have the convenient excuse that all postal systems have an element of monopoly which, they claim, indicates that natural monopoly must exist. A non sequitur!

The 'natural monopoly' rationale has been badly punctured in recent years. First there was the advent of competition in other industries often asserted to be naturally monopolistic. The successful liberalisation of telecommunications in the United States, the more limited steps in the United Kingdom and the process beginning in Japan are all evidence that the industry – except maybe at the local exchange level (see Albon 1986a) – is not a natural monopoly. The deregulation of United States airlines in the late 1970s has shown that airline operations are fundamentally in the same case.

Secondly, witness the success of private postal operations in areas where competition has been allowed. The growth of the couriers has been spectacular in Britain, the United States (where a postal broking industry has developed), Australia and elsewhere. Adherents to the natural monopoly argument could not have predicted that competitors, faced with various disadvantages, would successfully develop systems side-by-side with the official one. It must be remembered that these systems duplicate all aspects – collection, sorting, carriage and delivery – of the government service which usually has financial advantages as well as (in some cases) the ability to compete unfairly by using profits from its monopolised parts in order to support loss-making activities. The Post Office now acknowledges the existence of other parcel operations with a national coverage.

In the light of this, those who believe in a postal natural monopoly have retreated to assertions that standard mail is

naturally the exclusive domain of a single operator who, nonetheless, requires statutory protection from competition. However, it is hard to find the naturally monopolistic analogue to the local telephone exchange in telecommunications, itself not a clear candidate for protection from competition.

Collection of mail is a problem that has already been solved by couriers who pick up directly from senders or use central mailing points. In the United States there is a national brokerage service with private post offices – who deal with various courier companies – operated by World Mail Center Inc. This service charges customers the courier's normal rate and profits by paying operators a lower bulk discount rate. In Australia, courier companies have set up post boxes for prepaid envelopes at places such as service stations and supermarkets – a development now beginning in Britain. Various businesses which act as agents for other pick-up systems (e.g. film developing and printing through chemists) could be used by private mail operators. Perhaps even existing pick-up transport systems could be adapted for wider uses. The prospects are vast and it would require only the release of competitive forces to discover appropriate systems. However, in some rural areas it is possible that special steps might have to be taken to ensure the same standard of service after liberalisation. This is discussed in the next chapter.

Sorting, accounting for perhaps one third of total mail costs, is another area of possible concern. Again we find that courier companies and other operators have been able to set up relatively small-scale sorting operations, usually on a hub-and-spoke basis. Could this extend to larger quantities at much lower costs per unit, as required by standard mail type operations? While it is difficult to give much more than an opinion (because all standard mail around the world is monopolised) it would be surprising if a free market did not result in at least one large-scale standard mail operator (perhaps via a link-up of local and national operations) in addition to the Post Office. At various places around the world centralisation of mail sorting has proved disastrous and postal administrations have reverted to decentralised systems. A classic example (one noted by Britain's Carter Committee) is that of Australia Post. In Sydney, the centralised and, for its time, highly-automated, Redfern Mail Exchange (which opened in 1965 to handle all of Sydney's mail) resulted in higher, not lower,

unit costs. The mistake was obvious, and decentralisation began less than ten years after its opening. The central exchange has now been replaced by seven regional centres serving the city.

Government-owned official systems have not only experienced trouble in centralising operations, but also in introducing labour-saving equipment and employing casuals at peak times – all problems which would be less daunting to private postal companies operating in a competitive environment. Often in history it has been private operators who have shown the way in lowering costs and improving services; and this phenomenon would probably be observed in sorting.

Mail delivery, at present accounting for another thirty per cent or so of costs, is another area sometimes regarded as being 'naturally' monopolistic, particularly delivery to households, and in country areas. While such country areas may have to be given special consideration, competition in delivery to suburban households and businesses does not appear to present any problems. Already houses have regular deliveries from one or more sources – postmen, milkmen, newsboys and a host of handbill deliverers. If there are economies of scope in deliveries, why aren't these functions integrated into a single operation in urban areas (as they sometimes are in rural areas)? If, surprisingly, this did present a problem, there are several possible solutions. The most likely one would be for the industry to develop specialised delivery companies which would deliver mail and other items on a contract basis for other mail carriers. These delivery companies would have no statutory protection from competition and would probably be highly contestable.

Of course, a major part of the new entry that does occur will be on a local basis and on heavily-used inter-city routes (e.g. London-Birmingham). When asked to consider the sort of competition that might emerge if the monopoly were removed, it was this type of operation that the Post Office (1979) envisaged. It was thought that next-day local deliveries of 6p (compared with the first-class rate then at 9p) and a link-up of local delivery companies and a national premium network 'might just reasonably create a seriously competitive equivalent to the first-class letter service' (6.4). This was also the sort of entry that so worried the Post Office one hundred years ago, principally because it threatened its overall profitability and its ability to

charge a uniform price. Alfred Marshall (see Coase, 1961) had argued for freedom of entry on the basis that this type of competition would have a 'vivifying' impact on the 'slothful' Post Office, causing its 'stiff joints . . . [to] become more supple'.

The natural monopoly argument, which has already been found wanting, should, then, be further put to the market test in 1988 by complete removal of the statutory monopoly. This has been suggested strongly by Senior (1970 and 1983) in two Institute of Economic Affairs' papers on the British postal industry. Baumol (1983) has made a more general appeal – there 'may be no more effective test of contestability of the market and the presence or absence of natural monopoly than the ability of competitors to survive. The process . . . may perhaps be judged by some to be wasteful, but it can be argued that the survival of the fittest, through which the market normally achieves its efficiency, does exhibit similar patterns' (p. 27). All available evidence suggests that the process in this case would *not* be wasteful.

Another related point should also be made. A valuable lesson from the theory of contestability is that it is not necessary for new operators actually to arise for competition to do its work in stimulating greater cost- and allocative-efficiency. What is vitally important is that there should be no legal barriers to entry, so that an existing operator will know that there are others who can move in and take advantage of any poor performance. In the case of the postal industry there is no question but that new entrants will emerge, at least at the local and inter-city levels.

Finally, the setting-free of market forces would tend to push postal rates nearer to unit costs (which themselves may fall), and thus put an end to cross-subsidies now built-in to the system. While some may rue this particular outcome, the general argument holds that, on grounds of both equity and efficiency, the postal industry should not be a vehicle of awarding political favours on an implicit basis, nor should it be a medium for implementing welfare policies. If it is to be so used any subsidies should be quite explicit. The next chapter discusses the cross-subsidy issue at length and argues that rural subsidies and a competitive industry need not be incompatible.

Privatisation of parcels division (1989)

Once having been made a plc fully-owned by the Post Office and subject to completely open competition since 1987, and having been split administratively from the other original Post Office operations since 1986, the Parcels Division should be privatised in 1989, leaving only the Letters Division under government ownership. The parcels and courier operations would then be under the strict market disciplines of competition, identifiable ownership and susceptibility to take-over in the market for corporate control.

Privatisation of letters division (1990)

1990 would see the completion of a four year programme of liberalisation and privatisation of postal services in Britain, giving her the only completely competitive private postal system in the world. The final step would be as dramatic as that occurring in 1988 with the removal of the letters monopoly. For the first time in history a standard mail service would be taken from the public domain and placed in private hands. It would be exposed to completely open competition from private firms, subject to the discipline of identifiable ownership and under constant threat of take-over. It would be free of all community obligations unless explicitly subsidised to undertake them. The only contribution it would make to the Government would be through normal business taxes on its purchases and profits.

7

Maintenance of rural subsidies

Difficult though it is to define 'cross-subsidisation', unarguably some measure of it exists in the inland letter service – which has a uniform price across all parts of Britain but large differences in costs of provision however these are defined (average, long-run marginal, etc). Thus, in effect, some users are taxed in order to provide a subsidy to others. Although this is allocatively inefficient it may, however, be justified on the grounds that, administratively, it would be more expensive to relate prices to costs than to leave things as they are.

No recent estimate of the extent of the aggregate urban-to-rural cross-subsidy seems readily available, but a figure of £15m was suggested in the late 1960s and a hint of the order of magnitude ten years later was contained in a Post Office paper. According to a paper from the Postmaster-General (1969), 'The provision of collection and delivery services in rural areas is . . . a very expensive feature of national postal services. Expenditure is estimated to exceed revenue by some £15 million per year' (p.10). Based on figures on the urban-rural cost differential presented in a Post Office (1979) study and cost movements since then, the 1985-86 figure could be about £120m (see Albon, 1986c).

Ian Senior, in his 1983 Research Monograph, makes much of the cross-subsidy issue and applies impeccable economic logic to argue for its ending consequent upon exposing postal services to competition. In so doing he may have under-estimated its political importance. Senior may also have been unsuccessful in his bid to allay the fears of rural sub-postmasters that privatisation and competition might put them out of business.

While it is difficult on the grounds of both efficiency and equity not to accept a 'user pays' principle in regard to postal pricing, it is as well to acknowledge the difficulties faced by politicians when politically-powerful groups stand to lose from particular actions even where the gains to others outweigh their losses (i.e. where there is a net consumer benefit). For this reason it is prudent to set out a means of compensating the losers which is consistent with reaping the maximum possible benefits from releasing market forces. Such a scheme was worked out in the

case of telecommunications and there is no reason why a similar plan cannot be devised for the postal industry. But before considering such plans it is worth making the following point.

A private, competitive and unsubsidised postal system will bring with it benefits as well as costs to rural dwellers. It will, for example, bring a greater variety of types of service and rates to many country users. The experience with deregulation of airlines in the United States was not, as many had expected, disastrous for rural users. Deregulation led to many new airlines springing up to service rural areas, using hub-and-spoke configurations and larger, more appropriate aircraft than were possible with the previous point-to-point system. Many areas now have more frequent services, and fares in the thinnest markets have risen only about 10-15 per cent in real terms over those prevailing under regulation with all its inherent cross-subsidies (see Bailey, 1986). 'Postal' entrepreneurs acting in a similar manner will almost certainly find ways to service rural areas which are surprisingly innovative and affordable. Different companies will interconnect with one another to provide comprehensive postal services, just as do telecommunications and airline companies in the United States. Interconnection between long-distance and local carriers is the observed practice in telecommunications where long-distance operators must normally hook-in to local exchanges to connect subscribers with each other. A similar, but smaller-scale phonomenon is now arising in Britain as Mercury's long-distance network comes into operation.

It is most improbable that any area would be left unserviced after the advent of competition. While it was not true a few years ago, the competitive parcels area now contains private companies with a total national service. This has been noted under the 'external threats' set out in the latest Post Office Report (p.17). However, if the Government wished to ensure that everyone continued to have access to mail services, it could consider establishing exclusive franchises in certain rural areas (such as northern Scotland, western Cornwall and maybe central Wales). The carriage of mail in and between all major cities and conurbations (including their surrounding districts) would be totally demonopolised and the rest of Britain divided up into regional franchise areas. The number of users outside the free zones (or Hill's 'primary distribution') would not be very large.

Local monopolists in the non-free areas would have sole rights to collect and deliver mail items of, say, less than 60 grams in the area and would be obliged to be common carriers. They would be subject to competition on all non-letter mail items. Each regional operation would develop links with larger carriers (such as the Post Office Letters and Parcels services) for the carriage of out-going mail and the delivery of in-coming mail. Senders from such areas would pay, at the time of remittance, for postage according to destination, weight, delivery-time required, etc. Prepaid envelopes for certain destinations would probably become available. Other rates would be negotiated with the operator who would act as a postal broker. Presumably deliveries of mail sent in the local area to addresses within the local area would be very cheap – perhaps cheaper than the current Post Office rate. Some major destinations (e.g. London or Birmingham) would also probably be quite cheap. Mail from one remote area to another could, however, be very expensive.

While this approach would ensure that every Briton had access to a comprehensive basic mail service, one major problem might arise if franchisees were tempted to exercise their monopoly power on basic letters and set charges for their services at levels above full costs (inclusive of a 'normal' profit). This eventuality could be handled either by regulation (as it is in the case of telecommunications) or by use of a system whereby applicants bid for the regional franchises on the basis of the fees they would charge for their services. This process is sometimes known as a 'Demsetz auction'.

A variant of the franchise bidding scheme could be considered to inject an element of subsidy into the provision of remote rural services. Franchise holders would be required to provide local delivery and collection services on basic letters at a specified charge below its costs, and bidding would be on the basis of specifying the subsidy necessary to operate the service at this set of specific charges. The bidder requiring the lowest subsidy would get the franchise for a given period. A form of this franchise bidding scheme has been used in the case of subsidised bus services in Britain, an experience which could prove a useful guide in reforming the postal industry.

There are several practical problems with this franchise-bidding type of approach (see Williamson, 1976). Apart from

these, the crucial question must be asked 'where would the money come from?' if local operators were to be subsidised. One possible source would be consolidated revenue funds, but this would scarcely be popular with the Treasury, and would incur deadweight efficiency costs when tax revenues were raised. This source of finance should, in the view of the author, be avoided if any alternative is feasible which carries lower economic and political costs.

One such scheme would be to impose a special 'tax' or surcharge on all mail sourced from urban areas, irrespective of which carrier handled the mail. While this tax would create an efficiency loss, it might be somewhat less than that which would arise from further raising of, say, marginal income tax rates. The proceeds of the surcharge or tax would be used to fund the subsidy pool. Trial-and-error experiments might be required to fix the amount of the surcharge so that it raised sufficient revenue to pay the subsidy. Further, there would probably have to be some sort of licensing scheme to form a basis for charging the levy.

Another, related, solution might be to charge Post Office (Letters) with providing a basic letters service in certain designated areas at the current uniform rate adjusted over time for inflation by reference to an index of postal costs. In other areas British Post would, of course, be free to set its rate levels as it chose. The cost of this subsidy could be spread over all mail movements by all carriers (other than the subsidised movements), by way of a surcharge. This surcharge would probably be quite small, perhaps 5 to 6 per cent, even if the entire cross-subsidy of £120m were retained. The disadvantage, however, with such a system is that there may not be sufficient discipline on British Post (Letters) to keep cost levels down in rural areas. Of course, there would be competition from other operators who could, under this scheme, offer basic letter services wherever they liked.

The approaches suggested here are designed to ensure that all Britons have ready access to at least a basic letters service at a reasonable cost after demonopolisation. The objective is to get the maximum possible 'vivifying effects' from marketisation and privatisation while protecting the reasonable demands of rural people. It must be recognised that the present regime rewards

some users at the expense of the vast majority. The removal of the unreasonable element of cross-subsidy must be seen as an added benefit to be expected from a private and competitive postal system.

8
Conclusion

By almost any criterion, the Post Office has performed well in recent years. This is a consequence of initiatives already taken and the threat of further government action. But, in the view of the author, the Government must do more if it means to ensure postal efficiency and dynamism in the longer term. Milton Friedman (1975) has pointed out, in regard to the United States Postal Service, that we should not expect a government monopoly to be anything else but costly, inefficient and technically backward. This judgement is perhaps a little harsh. Nonetheless, when a government monopoly exceeds expectations we are wise to look for reasons beyond the basic organisational structure. In this case we may well adduce not only reorganisation and enlightened oversight by the Government, but also the sword of Damocles suspended over the Post Office's head.

The Government has recently shown renewed interest in altering the postal industry's structure. A letter from the Secretary of State for Trade and Industry, Mr Channon, to the Chairman of the Post Office, Sir Ronald Dearing, welcomed the setting up of Girobank as a plc and urged the board 'to press ahead with the incorporation of the counters business as a subsidiary company' and 'to consider further application of this principle to the other main activities'. These suggestions, together with the comment about introducing private capital into Post Office activities have been interpreted as a strong hint that at least partial privatisation is being contemplated, after the division into four separate services.

Over the question of demonopolisation, however, political activity seems at a low ebb – or non-existent. Many observers (including economists of the stature of Alfred Marshall and Milton Friedman) have seen this as the key to postal efficiency. Further, it is a matter that must be decided before privatisation is implemented. While the Girobank issue can be handled separately from the question of postal competition, the other privatisation exercises (letters, parcels and counters) cannot. Privatisation with the monopoly intact will tend to cement

monopoly powers in place as, it may be argued, has happened with British Telecom, where liberalisation before sale was too little.

The unrestricted demonopolisation strategy carries possible political costs to the Government in that it will mean the complete end to cross-subsidies. These tend always to be received by well-organised and close-knit minorities at the expense of weak and diffused majorities, the former having much more political clout than the latter. Demonopolisation of postal services will meet with suspicion because it has not been tried, in a complete sense, anywhere in the world. Fear of the unknown will probably play a part. These factors, combined with the cementing effect of privatisation (if it occurs first) do not lead to optimism.

On the other hand, it must be emphasised that any government taking these brave steps may well receive much kudos. There will be many beneficiaries from a private and competitive postal industry who will have cause to be most thankful. The overall benefits, mainly felt by business and personal users in urban areas, will be substantial, far exceeding whatever may be necessary to compensate any losers from liberalisation. In short, the move towards laissez-faire will be an exercise in both principle and pragmatism. The criterion of net consumer benefit, propounded by Beesley and Littlechild, which should apply for all future acts of liberalisation and privatisation, will be satisfied.

Appendix

The Letters division handles both the collection and delivery of inland and international letters and the electronic mail services. Most, but not all, the inland traffic is protected from competition. The international and electronic mail services are open to competition. This division, with a 1985-86 turnover of £2153m, is the largest one within the post office group.

Parcels division, with a turnover of £425m in 1985-86, operates inland and international parcel services and the Post Office's courier service – Datapost. It operates totally within a competitive environment.

National Girobank, a wholly owned subsidiary of the post office, is a bank which operates mainly through post office counters.

The Counters division, with its network of Crown and agency post offices, provides counter services to the other three divisions and financial services to various government departments and instrumentalities. It has a *de facto* monopoly of government agency work, one-third of its activity deriving from the Department of Health & Social Security.