C.D. Howe Institute
Commentary

www.cdhowe.org No. 243, February 2007 ISSN 0824-8001

Public Services

Rerouting the Mail:

Why Canada Post is Due for Reform

Edward M. Iacobucci
Michael J. Trebilcock
Tracey D. Epps

In this issue...
Privatizing Canada Post would improve its governance, and introducing competition would provide economic discipline that does not at present exist, without imperiling universal service. Compensation for existing postal workers affected by reform would ease the transition.

The Study in Brief

Canada's postal system combines a government-owned monopoly on the letter mail market with a universal service obligation. This model is increasingly understood to be anachronistic, and incapable of responding to the worldwide changes that are transforming the postal sector.
These worldwide changes, or pressures, include:

- Email, wireless communications and the Internet, which are transforming business and personal communication habits;
- Postal operations themselves are evolving, owing to advances in information systems, postal automation and retail services, logistics, and distribution technology;
- The postal sector is going global, as national postal services face increasing competition from domestic and foreign competitors in different market segments.

An inefficient postal sector creates significant social opportunity costs, and in recent years many countries have undertaken postal sector reform, introducing commercial objectives through corporatization or privatization, reducing or eliminating legislative monopoly protections, and creating new mechanisms for financing universal service obligations.

In this *Commentary*, we report on the economics of postal reform, and review reforms in other countries. Among our findings: introducing competition with an eye to improving postal performance is an achievable goal, especially if set within a broader economic liberalization program. Reforms in the Netherlands and Germany, for example, produced competitive carriers whose growth and diversification strategies enabled them to become globally competitive postal and communications services companies. In numerous European Union countries, the competitive forces accompanying reform have driven major improvements in on-time or next-day delivery and other measures of service quality. And in New Zealand, where economic liberalization has been most sweeping, the proportion of letters delivered next day increased from 88 percent in 1988 to 97 percent currently.

In our view, extensive reform in Canada is due. Privatizing Canada Post would improve governance of the business, and introducing competition would provide a form of economic discipline that does not at present exist. Maintaining a commitment to universal service in Canada is properly addressed through targeted regulatory or financing schemes, not the blunt and socially costly combination of public ownership and monopoly that currently prevails.

The Authors of This Issue

Edward M. Iacobucci is Associate Professor, Osler Chair in Business Law, Faculty of Law, University of Toronto.

Michael J. Trebilcock is University Professor, Professor of Law and Economics, Faculty of Law, University of Toronto.

Tracey D. Epps is Lecturer in Law, University of Otago.

* * * * * *

C.D. Howe Institute Commentary© is a periodic analysis of, and commentary on, current public policy issues. James Fleming edited the manuscript; Diane King prepared it for publication. As with all Institute publications, the views expressed here are those of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Quotation with appropriate credit is permissible.

To order this publication please contact: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3; or the C.D. Howe Institute, 67 Yonge St., Suite 300, Toronto, Ontario M5E 1J8. The full text of this publication is also available on the Institute's website at www.cdhowe.org.

$12.00; ISBN 0-88806-705-4
ISSN 0824-8001 (print); ISSN 1703-0765 (online)

Two features characterize Canada's postal system: a government-owned monopoly on a defined portion of the letter mail market, and a universal service obligation. The monopoly provides Canada Post with a reserved area in which it is the only legal provider, while the universal service obligation requires it to deliver letters and parcels ubiquitously. In many countries, this postal system model is increasingly seen as inconsistent with economic liberalization and deregulation as well as with the reality of changes being forced upon postal sectors worldwide (UPU 2002). At least three main changes can be identified. First, developments such as e-mail, wireless communication devices, and the Internet are transforming business and communication patterns, calling the future of letters into question.[1] Second, postal operations themselves are evolving due to developments in information systems, postal automation and retail services, logistics, and distribution technology. Third, with growing globalization of the sector, national postal services face increased competition from domestic and foreign entities.

These pressures challenge the viability of the status quo public monopoly. In addition, theory and experience suggest the possibility of significant economic gains from reform. Significant social opportunity costs arise from an inefficient postal sector, and many countries have undertaken postal sector reform to introduce commercial objectives, along with corporatization or privatization. As well, the scope of traditional postal monopolies is being reduced or eliminated to provide for more competition. Operators are responding to these changes in the regulatory environment by, for example, reducing costs and improving service.

This *Commentary* examines Canada Post in the context of an evolving postal sector worldwide and makes recommendations for policy directions that would best serve its stakeholders. We review issues concerning the ownership and regulation of Canada Post; examine the economic literature on postal reform; and discuss postal reform in other countries. The comparative analysis offers lessons for Canada, both from reforms that have been successful and those that have not. Our last section provides recommendations for Canadian postal reform policy.

In our view, extensive reform is appropriate. Privatizing Canada Post would improve governance of the business, and introducing competition would provide economic discipline that does not at present exist. While there would be residual concerns from such reform, such as maintaining a commitment to universal service, these concerns are better addressed with targeted regulatory schemes, not the blunt combination of public ownership and monopoly that we have at present.

Canada's Postal Sector: At a Crossroads

To substantiate our calls for reform, we first describe the system as it exists. This section provides an overview of the Canadian regulatory regime, taking into

The authors wish to thank Finn Poschmann and anonymous referees for helpful comments.

1 In 2002, the number of pieces of first class mail delivered in the US declined by 1.28 billion pieces or 1.23 percent, the largest recorded percentage decline ever. For standard mail, which consists mainly of advertising, volumes declined by 3 percent in 2002 (Geddes 2004). Worldwide, since 2001, the number of domestic letter post items has decreased slightly, with a fall of 0.4 percent in 2003. In terms of international letter post, the drop has been more significant, measuring 5.1 percent in 2003 (UPU 2004a).

account events of the past 25 years, and concludes with a discussion of key challenges facing Canada Post.

An Overview of the Regulatory Regime

Campbell succinctly describes the situation in Canadian postal services as it stood in 1981:

> The [Post Office Department] was highly scrutinized politically, political forces set its agenda, and political interference was the rule not the exception. Postal policy was neither rational nor effective … the Post was always cash poor, seriously undercapitalized, and old-fashioned operationally .… It ran deficits in every year from 1964 to 1981 .… Rising deficits paralleled growing labour unrest … postal strikes in 1965, 1968, 1974, 1975, 1978, and 1981 worsened what was an unreliable postal service …(Campbell 2002, 277.)

The *Canada Post Corporation Act* (the CPC Act) was enacted in 1981 to respond to these issues, by transforming the Post Office Department into a government-owned corporation.[2] Outside the civil service, the Corporation could attract professional managers, who would direct the Corporation within a long-term set of business strategies and better respond to market changes, as opposed to being limited by short-term political considerations. Crown Corporation status, the government believed, would create a more effective framework for managerial accountability, and the Corporation would have the ability to bargain directly with employees.

Monopoly and Universal Service. The CPC Act confers an exclusive statutory monopoly on Canada Post in respect of the collection, transmission, and delivery within Canada of "letters"[3] not weighing more than 500 g. The monopoly is subject to a number of exemptions, including delivery of magazines, books, and electronically or optically transmitted material, and urgent letters subject to a fee at least equal to "three times the regular rate of postage payable for delivery in Canada of similarly addressed letters weighing fifty grams."

Ownership and Governance. Canada Post Corporation is fully owned by the government. It is subject to the *Financial Administration Act* 1984 (FAA), which states that Crown corporations are ultimately accountable, through a minister, to Parliament, for the conduct of their affairs. While Canada Post has a degree of corporate autonomy, government maintains substantial control: Canada Post is overseen by a chairman and nine other directors who are named by the

---

2 This fact set Canada's reform experience apart from that of other countries where postal reform was driven by a broader economic agenda, rather than by postal-specific issues. Campbell (2002) suggests that the purely postal agenda of the 1981 reform resulted in it being an intensely political exercise, which would shape the future course of the post.

3 Letters are defined in the Letter Definition Regulations (SOR/83-481) as "one or more messages or information in any form, the total mass of which, if any, does not exceed 500 g, whether or not enclosed in an envelope, that is intended for collection or for transmission or delivery to any addressee as one item."

responsible minister, and the president is appointed by the Governor in Council.[4]

Post-1981 Reform. Following the 1981 reform, Canada Post came under repeated pressure from the federal government to eliminate any operating deficit. Struggling to meet its statutory objectives, in 1982 it reduced frequency of mail delivery in rural areas from six to five days and reduced multiple deliveries to businesses to one delivery per day. Other steps included converting some post offices to privately owned, franchised operations that offer retail postal services along with other goods and services, and the closure of some post offices.

After the election of a Conservative government in 1984, Canada Post followed a more competitive agenda, contracting out some non-core activities, offering clients incentives for pre-sorting their mail, introducing user-pay pricing, and reducing cross-subsidization. Canada Post became a key player in the Canadian courier market in 1993 when it purchased Purolator, a private-sector courier company.

The Mandate Review and the 1999 Framework Agreement. In 1995, the federal government commissioned a mandate review of Canada Post (Radwanski 1996), which resulted in the 1999 Framework Agreement, establishing a quasi-contractual relationship between the government and Canada Post. The agreement set a five-year timetable to reach stated financial goals and established a price-cap formula for first-class mail that allows Canada Post to increase the price of a stamp by a rate no more than two-thirds of the increase in the consumer-price index. The financial goals included profit targets and dividend expectations, although the details have not been made public. The agreement did not include any type of charter or customer-service accountability, or details as to Canada Post's service obligations or expectations about performance targets. The government had rejected the report's recommendation to appoint some sort of governance or regulatory supervisor to evaluate and track Canada Post's activities against specific targets.

The Challenges Confronting Canada Post

Notwithstanding its profitability in the past 11 consecutive years (Canada Post Annual Report 2005), Canada Post faces major challenges. Mail volumes are decreasing, as domestic consumers increasingly favour electronic communications, and business mailers seek to lower their costs by using electronic alternatives. The latter poses the greatest challenge as the business and government sectors, which account for 90 percent of Canada Post's letter mail and addressed ad mail volumes, have strong incentives to adopt electronic alternatives. Compounding the problem of volume erosion is the fact that while mail volumes are decreasing, the number of addresses in Canada is rising by approximately 240,000 per year. This is problematic given Canada's geography: rural retail network costs, growing

4 According to Canada Post's 2005 Annual Report, the Board exercises judgment in the following areas: establishing the strategic direction for Canada Post; major contracts; safeguarding the resources of Canada Post (including the real estate assets); monitoring corporate performance; establishing and implementing processes for the recruitment of senior officers and Board members; and reporting to the Crown.

at, or above, the rate of inflation, put pressure on Canada Post's financial resources (Canada Post 2005). As well, Canada Post is restricted by a price-cap formula set out in the Framework Agreement. It noted in its 2005 Corporate Plan that had the basic letter rate increased at the same level as the rate of inflation since 1995, the basic rate would have been 52 cents instead of 50 cents in 2005. This difference represented approximately $50 million in revenue.

Labour issues also pose a challenge for Canada Post. The dominant union today is the Canadian Union of Postal Workers, whose strength creates difficulties for Canada Post when looking to improve efficiency and productivity.[5]

Further, Canada Post faces increased competition from international shipping and delivery companies. These companies have been acquiring, consolidating, and working with courier, air freight, logistics, and ground-carrier firms, and expanding and integrating their networks, putting downward pressure on prices. As well, some global players have expanded their retail and online presence, enabling them to reach the consumer and small business segments, the source of a significant portion of Canada Post's business. For example, UPS and FedEx have captured a significant share of the small packages courier market. In 2000, UPS made a NAFTA Chapter 11 claim against Canada, arguing that Canada has not met its obligations to adequately supervise Canada Post's letter mail monopoly, which has been used to unfairly harm foreign competitors in Canadian markets.

Other challenges include changes in the transportation industry. Pressures are being placed on the domestic air cargo industry by high fuel costs, new security rules, changes in commercial airline fleet size, and schedules.

The Economics of National Postal Services

Another building block in the case for reform is an analysis of the advantages and/or disadvantages of public ownership and monopoly.

The Relative Efficiency of Private For-Profit Enterprises and State-Owned Enterprises

National postal services have traditionally been organized as state-owned enterprises (SOEs) with monopoly mailing privileges over defined classes of mail

5 Canada Post claims that: 16 days per full-time employee were lost to absenteeism in delivery and mail processing operations in 2005, 60 percent higher than the Canadian average for manufacturing employees and 20 percent higher than the rate for all unionized employees; on average, approximately 10,000 employees are on modified duties in a given year, two to five times higher than industry average; Canada Post delivery and processing employees whose duties have been modified due to disability are at double the industry norm in terms of duration; due to "pay for time not worked" clauses, based on analysis conducted in 2004, it is estimated that unionized Canada Post workers are working less than 64 percent of their paid time, approximately 10 percent less than the estimated average of other unionized, comparable companies in Canada; Canada Post has over 400 grievances per 1,000 employees with a current total of 27,000 grievances in the system; Canada Post has low parcel margins driven by a high cost structure; and parcel sorting costs are estimated to be close to three times higher than the competition (information provided by Canada Post, 2006).

by reference to size, weight, or type of mail. Such enterprises have typically been politically accountable for their performance to a designated minister of the central government and/or central agencies of government. We situate the debate about alternative structures for national postal services in the broader framework of the relative efficiency of private, for-profit service providers and state-owned enterprises with monopoly franchises over comparable services. We may evaluate the relative efficiency of these two classes of enterprise by reference to two effects: the ownership effect; and the competition effect (Smith and Trebilcock 2001; Trebilcock and Iacobucci 2003; Hrab 2003).

The Ownership Effect. The ideal ownership structure in terms of management performance is the owner/operator. Where there is no separation between management and control of a firm, the enterprise's efficiency gains accrue to the owner/operator, who then has every incentive to operate the firm efficiently. This type of ownership structure, however, places serious limits on the availability of capital to the firm. On the other hand, when outside investors supply capital, agency problems result from a divergence between ownership and control.

A number of mechanisms in the modern public firm help minimize agency costs (Berle and Means 1956; Jensen and Meckling 1976). External market pressures alleviate the lack of managerial incentives to improve firm performance, and the job market rewards management skills. The takeover market punishes poor management skills. The product market may, at the limit, punish poor management performance with unemployment via bankruptcy. Finally, managerial performance in the modern corporation can be improved by linking managerial compensation to firm performance (which is easily identified by share prices and firm profits).

The market's impact on SOE managerial performance is limited, in part because managerial appointments may be based on politics rather than merit. SOEs are not subject to the takeover market. And because governments rarely permit SOEs to go bankrupt, the product market has less impact on managerial performance. Finally, at least with respect to state-owned SOEs, compensation incentives are limited by the absence of share price information about managerial performance. Indeed, SOE managers may have sizable incentives to interfere with SOE efficiency: like other bureaucrats, they may aim to maximize pay, power and prestige, which goal is accomplished through budget maximization, not efficiency (Niskanen 1971; Trebilcock et al. 1982).

Monitoring incentives are weaker in SOEs than in the modern corporation. Where there is a controlling shareholder in a corporation, its investment will obviously warrant monitoring firm management, and an institutional investor will often have an investment large enough to make monitoring profitable. SOEs are owned by the state, in contrast, and each citizen of the state can be considered a shareholder of the state's SOEs. The cost to a member of the public of sifting through two levels of government bureaucracy (SOE managers and the government ministers responsible for them) to determine the source of SOE inefficiencies and attempt to correct them would far exceed the economic benefits that improved SOE performance would generate for that individual.[6]

6 See for example: De Alessi (1980), Shirley et al. (1995), Stevens (1992), Trebilcock and Prichard (1983).

In contrast to the overarching objective facing private enterprise — profit maximization — SOEs may have multiple economic and non-economic objectives.[7] Owing to political instability, moreover, these objectives may conflict or vacillate (Economic Council of Canada 1986). Thus, it is difficult for SOE monitors to assess the performance of SOE managers, who can blame poor enterprise performance on the SOE's non-commercial objectives. Meanwhile, just as SOE managers have incentives to turn SOE performance to their own ends, so too do the government ministers responsible for SOEs,[8] creating another obstacle to the private monitoring of SOE performance. If the heads of government do not want change in SOE performance, private monitors are likely to have little success in doing so.

The Competition Effect. Not only does private enterprise offer better management incentives, better monitoring incentives and capabilities than government ownership, private enterprise also fosters competition. Competition engenders allocative efficiency by removing from the monopolist the ability to set prices and assigning that role to the market. When producers in a competitive market are earning economic profits, other producers will enter and supply consumers with goods until the price of the product has been driven down to the marginal cost of production. In this way, consumers' demands are brought in line with marginal costs of supply and the deadweight loss associated with monopoly production is eliminated.

Competition improves efficiency by encouraging producers to minimize costs. Productive efficiency becomes a matter of a competitive firm's survival, as does constant attention to dynamic efficiency in adopting new products and processes. Monopolists do not face the threat of failure from higher costs or obsolete technology. Competition also provides clear information on relative management performance.

Of course, monopoly is not peculiar to public enterprise. Natural monopoly arises in the private sector where there is a unique source of supply of a raw material, or when economies of scale enable one firm to supply the entire market at a lower price than that which could be charged by two or more firms. These types of private monopoly can be, and typically are, subjected to economic regulation.

Given the need for regulation, one might argue that public ownership might be appropriate in such circumstances. This argument, however, ignores the negative effect of public ownership discussed above. Moreover, so-called "natural monopolies" that have been nationalized and operated as a single entity are often divisible into parts, some of which are amenable to competition. For example, while the transmission and distribution systems of electricity and gas are true natural monopolies, competition is feasible in the generation of electricity and the production of gas and the retailing thereof. Similarly, long-distance telephony is a competitive market while the local switching network may not be (but may soon

---

7 In fact, a manager will often face as many sets of multiple objectives as government officials/bodies having control over his or her SOE, for example, senior bureaucrats, ministers of state, the head of state, etc. (Jones 1991).

8 SOE managerial posts may be used to reward specific supporters, and SOE demand prices (labour, inputs) and supply prices may be used to win broader political support.

become so with wireless telephony and VOIP); airline services are competitive but airport facilities often have local monopoly characteristics.

Empirical evidence supports these theoretical hypotheses about the benefits of competition and privatization. In a recent comprehensive review of the empirical evidence on the privatization of SOEs, Megginson and Netter (2001) report that private actors economically outperform public agents in the provision of goods and services: productivity and profitability increase when SOEs are privatized. Geddes (2004) surveys the views of 10 so-called "vital economists" who have produced substantial scholarly research on postal services and who have expressed an opinion on the direction that reform should take. In his review, Geddes reports that all but one of these economists favour some combination of de-monopolization and privatization. We discuss the minority views below.

Evaluating the Case for Exceptionalism with Respect to National Postal Services

The Natural Monopoly Argument. Some argue that a postal service is a natural monopoly where economies of scale and scope and network effects make it most efficient for national postal services to be provided by a single entity. If this were true, however, it would be unnecessary to impose legal restrictions on entry, as new entrants would not be able to compete with a natural monopoly (Priest 2004). Time would tell whether national postal services were a natural monopoly, as determined by the normal interplay of market forces. Additionally, if natural monopoly did exist, it would not justify restrictions on entry, but rather some form of price regulation — perhaps a price cap or performance-based regulation designed to prevent the abuse of market power.[9] Moreover, the question of whether postal services are a natural monopoly obscures the issue of whether segments of the postal service market are inherently competitive while other segments are not. Network industries such as telecommunications, electricity, and natural gas, once regulated as vertically integrated monopolies, are now recognized as having some inherently competitive segments and others that may not be. Contemporary policy evolution in many countries has recognized this by liberalizing entry into the competitive segments and regulating prices within the inherently monopolistic ones.

The Universal Service Obligation (USO). National postal service operators have been subject to a Universal Service Obligation, which typically requires them to provide mail service at uniform rates to all regions of a country, often accompanied by requirements relating to service frequency and quality. The rationale for a universal service obligation historically, at least in North America, was to promote economic development by reducing one of the costs of settling in remote or under-developed areas of the country, and promoting national unity by enhancing social communication and cohesiveness. Conventional wisdom, in assigning a USO to postal operators, is that an exclusively reserved category of mail is required so that

9 However, it should be noted that under relatively stringent conditions, both regulated and unregulated multiproduct natural monopolies may attract wasteful, inefficient entry (see Panzar and Willig (1977); and Baumol, Bailey and Willig (1977).

routes where postal revenues exceed costs provide the resources to finance uniform service in less densely populated or remote communities. Without an exclusive privilege, goes the argument, competitive entry would lead to cream-skimming on high-density routes, leaving the national operator with money-losing routes and requiring ongoing government bailouts or subsidies.

A number of objections can be raised to this rationale for a legally protected postal monopoly. First, it is not clear that the USO requires strictly uniform prices and services across regions. As with other goods or services provided to remote or sparsely populated communities, one of the burdens of residing in such communities is the additional transportation and communication costs of providing goods and services over longer distances. The costs of travel to a hospital, for example, or the cost or scarcity of public transportation, are more burdensome for rural communities. Similarly, it is reasonable to imagine a relatively uniform package of services provided both to high-volume and low-volume routes but priced differentially to reflect the costs involved. Alternatively, service frequency and quality might vary across routes. In urban areas, many postal services involve door-to-door delivery, while on rural routes service is provided to roadside mailboxes or local post offices.

But even if for political or other reasons, uniform pricing and a uniform package of services are deemed essential elements of a USO, this does not require a legally protected monopoly over first-class mail. Many jurisdictions have forms of universal service obligations that do not entail cross-subsidization. For example, they provide direct and targeted government subsidies to postal operators to maintain the requisite level of service and rates on specific routes. The subsidies simply become an additional source of revenue to operators servicing those routes, and are consistent with a level playing field for competition. Such subsidies can be financed either out of general revenues or through a tax or required contribution based on sales of all operators. A further refinement may be to put out losing routes to competitive tender and award such routes for defined periods of time to either publicly or privately owned postal operators that are prepared to operate these routes for the lowest subsidy.

A subsidy policy has the virtue of political transparency in that explicit, direct, and targeted subsidies can be more meaningfully evaluated in the political process than implicit and untargeted cross-subsidies buried in overall postal rates. In addition, it removes excuses for not achieving financial performance targets owing to uneconomic social objectives being included in the organization's mandate. Finally, adopting an explicit and targeted subsidy strategy removes from competitors the claim that competition by the national postal operator, outside the exclusive sector, is an unfair form of competition sustained by cross-subsidies from revenues generated by the legally protected monopoly. The strategy is thus likely to enhance competition in hitherto protected and unprotected segments of the sector, to the benefit of users of mail services in both classes.

As we will see, these subsidy mechanisms are not purely idle speculation and have recently been adopted in a number of countries that have embarked on reform of their postal sectors. We have the striking example of the adoption of an analogous policy in Canada in the telecommunications sector. Following liberalization of that sector and the removal of legally imposed restrictions on competition, all telecommunications service providers fund the USO through contributions.[10] In high cost areas, where the cost of providing residential local telephone services exceeds sales revenue, the CRTC has established a per-customer subsidy program to ensure service. The subsidy regime is competitively neutral, in that it moves from one provider to another if a customer switches providers. The subsidies, which totaled $248 million in 2005, are funded by a tax — 1.03 percent in 2005 — on revenues of telecom providers with more than $10 million in annual revenues.

It is not obvious why a similar regime could not work in postal markets. Moreover, even within the Canadian postal sector, targeted subsidies are already provided to finance mailing privileges for parliamentarians, the blind, Canadian newspapers and periodicals, and the shipment of perishables to remote northern communities.

Public Ownership of the National Mail Operator

To this point, we have been principally considering the competition effect of alternative policies. However, some commentators object in principle to privatizing the postal service. Bickerton (2004) argues that most postal administrations are mandated to fill the dual roles of providing a public service to the population and acting as a commercial entity and that these objectives frequently come into conflict. Resolving this conflict is, on this view, an inherent function of the democratic process. While we do not deny that maintaining a USO entails recognizing non-economic or social policy objectives, we are of the view that debate should focus less on the objective and more on the array of instruments available for achieving it most efficiently. Choosing the appropriate instruments and their financing is a political decision, but the preservation of a public postal monopoly is almost certainly not the most efficient option open for achieving this objective.

Other Objections to Liberalization and/or Privatization

In Canada, as elsewhere, the National Postal Operator often has employed a heavily unionized workforce, and postal unions (in particular the Canadian Union of Postal Workers in Canada) are strongly opposed to policy directions that espouse liberalization and/or privatization (Bickerton 2004). We briefly review the objections that we have yet to address.

Deregulation hurts postal workers. Bickerton argues that in the absence of a monopoly, unionized workforces are likely to face job losses and erosion of wages and benefits in the face of competition from non-union, private-sector competitors. By parity of reasoning, however, General Motors should be given a legally protected monopoly in the auto manufacturing business so that its workforce can capture a substantial share of the monopoly rents, or the trucking industry should be transformed into a monopoly for similar reasons. Even accepting that unionization of postal workers provides a social good, surely the appropriate

10 Thanks to Jonathan Daniels for a helpful description of the subsidy mechanism.

response of the unions is to become "organizing" and not merely "servicing" unions, and to attempt to organize the workforces of competitors in the postal sector.

Bickerton also argues that the density of delivery would decline with deregulation, resulting in a higher proportion of outside delivery time for letter carriers, less money available to improve working conditions, and pressure to increase workload and extend working time in line with competitors. We do not deny that in a more competitive environment there will be pressure on both management and workers to improve productivity to be able to compete effectively with private sector competitors. This is precisely the point. To the extent there are concerns about working conditions, this is what labour and employment laws are for. Maintaining a state-owned postal monopoly is not a sensible instrument for creating appropriate working conditions in the postal sector.

Deregulation will result in deteriorating service. Bickerton argues that new competitors may attempt to obtain market share by offering improved services to customers but often will not offer superior services, only lower prices, leading to cutbacks in services.

Offering a different service-price package than that offered by the current state monopoly is healthy competition: if customers prefer less service for less money, it is a social gain for them to be able to purchase such a package. Moreover, the large share of Canada Post's mail volumes and revenues derived from business and government users suggests that reducing mailing costs for business users is likely to produce benefits, not only for them but for their customers. Competition is likely to also sharpen incentives to innovate. For example, competition in the telecommunications sector has led to new and dramatically superior services.

Deregulation will hurt the environment. Bickerton argues that by introducing competition into the presently protected letter market, more firms will be competing to provide the same, or declining, mail volume, leading to more traffic congestion and environmental pollution.

If this argument were valid, we should force all citizens to use the public transit and abandon their motor vehicles, or create a monopoly in the trucking sector, the airline sector and many other sectors. Instead, our society has sought, through tax, regulatory and other policies, to internalize (albeit imperfectly) the costs of congestion and air pollution to those who cause it.

Deregulation will reduce the security and privacy of the mail. Bickerton argues that competition will jeopardize the guarantee of security and privacy of the mail, once private competitors enter the hitherto protected sector.

This concern, however, simply argues for appropriate monitoring and enforcement services encompassing private competitors. Likewise, an argument for creating a monopoly in the transportation industry, because monopoly would make it easier to monitor the transportation of illegal, hazardous or contaminated goods, could not survive close examination.

In summary, we believe the case for de-monopolizing the Canadian postal sector, and moving to some substantial degree of private ownership, is compelling and consistent with developments in jurisdictions beyond Canada. Such policies do not obviate a role for government, first in financing uneconomic services, or for financing a USO on terms consistent with a normal commercial rate of return, or in some cases, arguably, regulating rates. Failure to rethink the role and mandate of Canada Post, given the dramatic technological transformation that is occurring in the communications sector, would be — in the words of Geddes (2003) commenting on the US Postal Service — to acquiesce in "a slow-motion train wreck."

Lessons From Other Countries

We turn to postal reform in other countries, under the following themes: the ownership effect; the competition effect; the universal service obligation; and the performance and labour implications of reform.

The Ownership Effect

In the international arena, the approaches to ownership include: maintaining the status quo, where the post office is a government department or has no commercial objectives; corporatization, where the post office becomes a government-owned corporation with commercial objectives; and privatization, where the post office is sold and no longer controlled by government.

Among industrialized countries, there has been a clear preference for moving away from the status quo, most often through transforming the post office into a government-owned corporation with commercial objectives. The United States Postal Service, for example, was transformed in 1970 from a Cabinet-level department to an independent establishment of the executive branch of the federal government with a mandate to operate on a break-even basis. In Europe, 18 of 25 public postal operators have been corporatized (Wik-Consult 2006).

Other countries appear to have been more successful in providing incentives for efficient management than the US and Canada. In the case of Canada, its 1981 reform was a response to problems identified with the postal service itself. Elsewhere, such as in Europe and Australasia, reform has been in response to a wider economic agenda of modernization of the state. In Europe, a European Union-wide agenda for modernization of the postal sector has been the driving force behind liberalization in the member states. In New Zealand, postal reform was driven by a broad economic policy of commercialization of the state-enterprise sector. As part of this strategy, the government sought to make the Post an efficient contributor to the national economy.

While the New Zealand government continues to own the Post and has the power to name board members and articulate policy objectives, the Post is directed to act like a private-sector firm. It is required to make a profit, to repay any loans it has with the government, to fund itself from its own earnings and private-sector borrowings, and to pay taxes and dividends. Further, it is designated a limited liability company, to ensure that government does not underwrite the Post's performance and that the board of directors places the interests of the business first, ahead of the government's interest.

Fewer countries have taken the privatization approach to ownership, the two principal examples being the Netherlands and Germany.[11] Both these countries are unusual in that the decisions to pursue a privatization agenda were in part premised on the ability of their postal operators to use their existing market positions as leverage to become world leaders in the sector.[12] Since 1989, the Dutch postal operator has had a high degree of autonomy and an unrestrained commercial mandate, which has allowed it to play an aggressive role in the world market.

In Germany, the postal department was converted in 1994 into Deutsche Post A.G., a corporation fully owned by the government. Today, the government owns 42 percent of shares through KfW Bankengruppe, a government-owned development bank (Wik-Consult 2006). Like TPG, Deutsche Post has followed an aggressive strategy of growth, diversification, and internationalization to become one of the world's preeminent postal and communications operators.

The Competition Effect

Other steps to liberalize postal sectors, to encourage competition, have involved reducing or removing the government-owned monopoly in one step, gradual reduction of the monopoly's scope by reference to weight and price, or gradual reduction of the monopoly's scope by reference to the type of service provided.

Several countries have taken the first approach. In 1991, Finland became the first European country to completely abolish the postal monopoly.[13] Sweden followed shortly thereafter, removing its monopoly in 1993. The Swedish government decided to repeal the monopoly following the emergence of CityMail, a company providing twice-weekly delivery of bulk, computer-generated mail destined for Stockholm and other large cities.

Both Sweden and Finland have systems requiring postal operators to obtain a licence in order to provide services. In Finland, any operator is entitled to provide postal services, subject to obtaining an operating licence.[14] Licences may restrict an operator either geographically, with respect to permissible types of postal items, or in some other way. Sweden has a similar licensing system, which aims to protect consumers through conditions such as requiring that a competitor postal operator be able to pursue a sustainable business.

Despite liberalization, Finland has not had significant competition in its postal sector.[15] There is more competition in Sweden, where Swedish Post's market share

11 Denmark, Belgium and Austria have also taken recent steps towards privatization.

12 See TNT online, http://group.tnt.com/investorrelations/stockinformation/shareownershipandcapital/index.asp.

13 Predating various Commission directives which triggered community-wide liberalization.

14 Pursuant to the *Act on Postal Services* and the accompanying *Decree on Postal Services*.

15 Two key obstacles face potential new entrants and therefore inhibit market entry in Finland. First, there are strict regulatory quality standards regarding delivery, which pose an obstacle to entry unless the new entrant has large volumes of postal items and substantial financial resources to ensure high-quality service from the first day. Second, Finland charges a tax to guarantee services in remote areas. The tax prevents cream-skimming strategies and ensures the provision of postal services in sparsely populated and remote areas. In addition, the Finnish market is small and ...

has been declining since liberalization. Its main competitor is CityMail, which has a market share of just over 8 percent, principally through delivery of pre-sorted mailings to Swedish households, as well as to other European countries (Wik-Consult 2006). Nevertheless, there remain high barriers to entry, particularly for provision of overnight, nationwide delivery of single items of correspondence. Sweden is also a large country with a low population density, making a nationwide delivery network difficult (Ecorys 2005).

The second approach to liberalization, the gradual reduction of the scope of the postal monopoly, is most common. In 1992, the European Commission proposed a maximum, membership-wide limit on the postal monopoly.[16] Directives that narrowed public monopolies over ever-smaller weight and price categories implemented this proposal.

Within this framework, member states have taken varying approaches to liberalization. The Netherlands has followed the Directives closely and has one of the most competitive postal sectors in Europe. It has applied a 100 g limit since June 2000 and has plans to completely liberalize by 2008, contingent on the creation of a level playing field through full liberalization in Germany and the UK.[17] Despite the absence of legal barriers to entry for new postal operators in the Netherlands, with neither licensing nor registration required to provide postal services, informal entry barriers remain. In particular, competitors have complained that TPG maintains a competitive advantage through its exemption from value-added tax. Nevertheless, liberalization has stimulated competition and a number of new entrants have entered the Dutch market.[18]

In Germany, Deutsche Post holds a statutory exclusive licence for mail weighing up to 50 g, or costing not more than two and a half times the rate in the lowest weight category. This licence will expire on December 31, 2007, when the government is aiming for full liberalization of addressed mail. Germany maintains a licensing system whereby all competitive postal operators carrying addressed mail weighing less than 1 kg must obtain a licence from the national regulatory authority. The range of licences permit competitive operators to offer postal services of differing quality, even if the class of items falls within the weight and price limits of Deutsche Post's exclusive authority.

A considerable number of postal operators have entered the German market and, at the end of 2004, there were over 1,000 active competitor postal operators licensed to convey letter items with a weight of less than 1 kg. Most of these, however, are small local companies that distribute mail in municipalities or a

footnote 15 cont'd

isolated, with stagnant mail volumes and, thus, liberalization appears to have done little to promote competition.

16 This proposal was contained in the so-called "Green Book" which formed the foundation for future developments in the postal sector in EU member states.

17 See TNT, Press Release, online at: http://group.tnt.com/pressreleases/nonfinancial/tnt/level_playing_field_a_justified_condition_for_postal_market_liberalisation.asp.

18 These companies are reported to be aiming to have an 8 percent market share each at the start of full liberalization and 20 percent by 2008, giving TNT a share of less than 60 percent. It has been suggested, however, that these forecasts seem to be exaggerated as they do not take account of new competitors (Ecorys 2005).

cluster of municipalities. In 2003, the total market share of competitive postal operators was about 4 percent (by revenue) and 3.75 percent (by volume) (Campbell, Dieke, and Niederprüm 2004). Because of the need for national coverage and the current limits on the number of distribution networks, competition at a national level is expected to be limited to two or three competitors covering the whole of Germany (Ecorys 2005).

New Zealand has taken a similar approach to the European Union, commencing deregulation of its postal sector in 1990 and completing the process in 1998. Since deregulation, New Zealand Post has faced competition from a number of private postal operators but has been largely successful in maintaining its market share by following a strategy of low prices and high-quality service. A group of competitors has argued recently that greater regulation is needed because there is no effective challenge to New Zealand Post, and that an independent authority needs to be established to determine the terms and conditions under which competitors can access the NZ Post network, to prevent NZ Post from stifling competition.

Australia reduced the scope of its postal monopoly, but has not gone as far as the above-mentioned countries. In 1994, the government introduced extensive exceptions to Australia Post's monopoly, and Australia Post remains the dominant market operator in Australia.

The UK has followed the third approach, with liberalization being divided into stages based on service type. It phased in competition beginning in January 2003 and, as of January 2006, ended all restrictions on market entry, other than requiring postal operators to acquire a licence to operate in the UK market. The postal services regulator (Postcomm) has exclusive authority to grant licences and to set conditions, and it must ensure universal service. The regulator has issued 13 licences, with the first going to Royal Mail in March 2001. Other than Royal Mail — whose licence is subject to a universal service obligation — these operators' market share is minimal. Factors cited as being responsible for the lack of competition include difficulties for competitors in obtaining access to Royal Mail's network, Royal Mail's exclusive exemption from value-added tax, and customers' resistance to change (Campbell, Dieke, and Niederprüm 2004). Moreover, Royal Mail itself has shown improvements in performance, undertaking a restructuring process in 2003 and recording an operating profit for the past three years (Royal Mail Annual Reports 2002/03 to 2005/06).

Spain has also taken the third approach by choosing to liberalize domestic intra-city postal items. About 40 percent of Spain's postal volume is open to competition, making it the most competitive market in Europe. This is largely due to letter post services within cities being historically freer in terms of competition. However, the incumbent operator, fully government-owned Correos y Telégrafos, remains the dominant operator in the market for delivery of letter post, with a market share of 89.4 percent of volume.

Universal Service Obligation

Following liberalization, a key concern of both governments and incumbent operators is to align the liberalized market with maintenance of the universal service obligation. A number of questions arise, such as: What entity should be responsible for guaranteeing universal service? How should the scope of the universal service obligation be defined? Should the universal service provider be compensated, and how?

Regarding what entity should be responsible for guaranteeing universal service, two approaches have been taken.[19] The first, exemplified by Germany and Sweden, is for the government to take responsibility for universal service. In Germany, if no operator can provide a service to an area at least at cost, the independent German government post regulator will put the area out for bids. The successful bidder, the one that can provide the service at the lowest subsidy, wins the routes. In Sweden, the government has contracted with Swedish Post to provide this service. A slightly different approach is taken in the UK, where the universal service obligation is legislated and the independent regulator of the postal sector ensures its provision, for the present by imposing conditions on Royal Mail's licence.

The second approach is for the postal operator to be charged with the responsibility for ensuring maintenance of the universal service. This is the approach of a number of countries, including Finland, the Netherlands, New Zealand, and Australia.

Aspects of the universal service obligation may vary, including price and frequency of delivery. In some countries, the scope of the universal service obligation is expected to diminish with further liberalization. For example, in the Netherlands, it has been proposed that while a universal service obligation should be maintained following complete liberalization, its scope may change over time depending on future demand for postal services. Likewise in the UK, where the government has suggested that following complete liberalization, the universal service will fulfill the role of a guarantee of a minimum, rather than a comprehensive, range of services. The services covered by the obligation may also vary. For example, the UK has removed most bulk mail services from the obligation (Wik-Consult 2006).

Some countries have maintained a daily delivery requirement despite liberalization. In Finland, all postal operators (not just the universal service provider) are required to collect and deliver mail on a daily basis and to deliver 95 percent of domestic items by the next working day. The *Act on Postal Services* only regulates prices to the extent that they must be "fair and reasonable in proportion to the average costs incurred."

Another question concerns compensation for the universal service provider. As noted above, the Finnish government requires postal operators to pay taxes on their turnover, which may constitute an impediment to new market entrants. In Germany, the universal service provider is to be paid compensation, to cover the difference between its costs and the break-even level, from a fund contributed to by all licencees earning more than 1 million deutsche marks annually. At present,

19 Different countries also take different approaches to defining the scope of the universal service obligation. In some, the universal service obligation is defined by statute: the Dutch government, for example, has statutorily defined the obligation to include mail items within and outside the reserved area. In others, it is defined by the postal regulator. In the UK, Postcomm holds responsibility for defining the universal service obligation.

however, Deutsche Post is the only postal operator capable of providing universal service nationwide. Given the lack of other operators, Deutsche Post is in effect required to cover most of the cost differential itself (Hudgins 2000). New Zealand takes a different approach. There, the Post receives no compensation for carrying out the universal service obligation, on the belief that its market position and branding advantage give it sufficient advantages and benefits in the market to finance its obligations (Campbell 2002).

In terms of pricing, some countries have introduced a maximum letter pricing approach rather than a universal one. In New Zealand, for example, the Post agreed not to raise the standard letter price above 45 cents and not to impose a surcharge on rural delivery. Other countries with price-cap regulation are Germany, based on so-called efficient costs, and Sweden, where prices for single correspondence are subject to a price cap based on actual costs.

Other countries maintain a system of a uniform rates. Australia Post, for example, is required to apply a single rate of postage to standard postal articles carried by ordinary post within Australia. In the UK, price is regulated on an ex ante basis, whereby services must be provided at affordable prices that are uniform throughout the UK.

Performance and Labour Implications

Overall, following reform, the countries we reviewed appear to have either maintained or increased service quality in terms of factors such as rates of on-time delivery achieved (Wik-Consult 2006; Campbell 2002). In the EU, for example, member states' transit-time targets are at their highest level since liberalization began, with 12 of them aiming to deliver 90 percent the next day and no member state with a target lower than 80 percent. Thirteen out of 25 member-states achieved their targets in 2005. (Wik-Consult 2006). In New Zealand, the proportion of letters delivered the next day after collection increased from 88 percent in 1988 to 97 percent currently (NZ Post Fast Facts 2006). In Sweden, reported improvements have included adapting products and services to demand, and price improvements for delivering pre-sorted or bulk mail, first-class letters, addressed advertising mail, and addressed magazines. This appears to have engendered popular support that has helped offset the union's otherwise negative reaction to the job losses incurred (24 percent of the workforce). In Germany, too, service levels have improved since liberalization: Campbell (2002) writes that prior to liberalization, a lack of market, service, or customer orientation was reflected in low-quality services and high losses. Following liberalization, corporate strategy was more market- and growth-oriented, with internationalization, diversification, and value-added products. In the Netherlands, where delivery frequency has been reduced, the quality of the service has otherwise remained stable.

In terms of pricing, the experience in a number of countries suggests that with appropriate regulatory incentives and strictures, prices can be held at reasonable levels. New Zealand has succeeded in doing so by maintaining a price cap, while Finland used regulations requiring that prices be fair and reasonable (Ecorys 2005). Overall in Europe, basic letter and parcel rates have increased in the majority of member states since liberalization. However, it has been noted that in many cases these increases mask reductions in the average price of postal services, realized in the form of greater discounts for large mailers and bulk mail (Wik-Consult 2006).

There are numerous examples of innovation by national postal operators as they seek to remain competitive following liberalization. In the Netherlands, for example, the Post implemented various hybrid mail products such as FAX-POST where customers fax a letter to any post office by 9.30 p.m. and a hard copy of the letter will be delivered the next day. In the parcel area, innovations include tracking and tracing services, electronic payment at the receiver's door, and the opportunity to submit shipping orders electronically. In Germany, Deutsche Post introduced E-Post, which is a service where firms submit electronic files that can be printed and delivered locally.

In each of the countries where reform has taken place, employment in the postal sector have dropped as operators have sought to rationalize and lower costs (Campbell 2002). Country strategies to minimize job losses and accommodate union concerns include attrition, early retirement packages, and an increase in part-time employment. The postal operator in the Netherlands kept job losses modest through such means, although it was aided by a concurrent growth strategy that avoided some expected job losses.

In some cases, operators have bargained with unions. For example, in Germany, a collective agreement was reached in 1997 whereby Deutsche Post agreed on no dismissals for operational reasons before December 2000, in return for being able to proceed with cost-cutting initiatives such as shorter breaks and elimination of hardship pay. In Australia, although the union has opposed postal deregulation, it did accept reform of industrial relations. The union apparently concluded that it was better to have a public postal corporation making profits, which could be used to maintain a social safety net for workers (Campbell 2002).

Implications for Canada

Evidence from other countries suggests that postal sector reform can produce efficiency gains and improvements in service quality. Many countries, however, implemented postal reform as part of a broader reform agenda, providing political impetus arguably lacking in the Canadian context.

Experiences in other countries must be tempered by recognizing Canada's unique geography, and that lack of liberalization in the US postal sector denies Canada Post some of the opportunities which benefited European providers. Nevertheless, some useful lessons can be drawn from the experiences outlined above, both positive and negative. While liberalization has generally positive effects on service quality, merely liberalizing a market does not mean that competition will follow, particularly where the incumbent operator has advantages such as tax exemptions. This is evident from Europe, where competition has been limited in the letter market, despite liberalization in the postal sector, and competition authorities have been increasingly involved in complaints of abusive behaviour by universal service providers who dominate national letter markets (Wik-Consult 2006).

It is thus critical, when changes in ownership or added commercial flexibility are introduced, that the new entity is subject to competition laws that prevent it from exploiting its dominant market position (Geddes, 2003). Even in New Zealand, where the overall experience of liberalization seems to have been positive, competitors of New Zealand Post have expressed dissatisfaction with the system, which they feel allows New Zealand Post to stifle competition. Regulating downstream access for competitors, for example, to sorting facilities and mailboxes, is thus an important aspect of reform.[20]

In Europe, most incumbent operators seem to have adapted well to reforms. A recent survey found that market opening seems to have had positive effects on the financial position of most universal service providers, with those facing liberalized conditions having increased their cost efficiency (Wik-Consult 2006). However, some commentators have expressed skepticism regarding the ability of those operators to adapt to full market liberalization (Finger and Mollet 2005).The case studies suggest that postal reform must include changes in market structure, through limitations on,or the elimination of, the postal monopoly, or changes in ownership. Minor alterations in organizational or regulatory structures are unlikely to improve performance (Geddes 2003). Finally, experience in other countries suggests that there are benefits from making the universal service obligation a government responsibility, to reduce the need for a postal operator to finance universal service through markups on urban delivery, implicit tax subsidies, or credit guarantees.

Summary and Recommendations

There is an opportunity cost to an inefficient Canada Post. Inefficiency results in reduced dividends or taxes paid to the government, which could otherwise use them to finance programs such as health care and education. Theory and evidence strongly recommend fundamental reform of the postal system in Canada. In particular, it would be desirable to privatize Canada Post and to abolish statutory monopolies for Canada Post or any other provider. Canada Post could continue to compete in providing mail services, and any other product or service, as would other postal firms. These changes would require other reforms, including addressing the universal service obligation.

We conclude by reviewing the benefits of reform and addressing concerns that would remain in such an environment. These residual matters are remediable through specific, targeted instruments, we stress, and not the bludgeon of a public monopoly. Finally, we review some of the obvious political obstacles to reform and offer strategies for dealing with potential political opposition to reforms that, while optimal, potentially lower some groups' welfare.

20 In Europe, two countries — Germany and the UK — have now mandated downstream access to the universal service provider's sorting facilities.

Theory and Evidence on Privatization and Deregulation

The theory is clear: there is an ownership benefit from privatizing, and a competition benefit from deregulation and liberalization. Under a privatized regime, Canada Post would be owned by shareholders, who would have greater stakes in performance and a greater say over management than the taxpayers who are the current owners. Shareholders could vote for boards of directors directly, or sell to a takeover bidder who could then vote the shares to oust incumbent management. Corporate governance and managerial performance would improve because of privatization.

Canada Post at present enjoys a statutory monopoly over certain mail classes. While it faces competition from substitutes, such as electronic communications, competition is not as robust as it could be without statutory barriers to entry. Abolishing Canada Post's protection from competition would potentially boost its incentives to keep costs down, and enhance service quality and innovation.

The evidence from postal reforms around the world is consistent: reform improves performance. Deregulating and privatizing postal operators has had a salutary effect on costs, and service has generally improved. The ownership effect has been influential in countries that have followed a privatization path, but the competition effect in countries that have deregulated has not always been substantial. In some countries, there has not been much entry following the abolition of statutory monopolies, perhaps because of remaining regulatory barriers to entry like excessive licensing costs. However, even in countries where there has not been entry, it is plausible that the threat of entry has exerted discipline on incumbent postal operators.

In the face of this theory and evidence, we conclude that the postal service in Canada should be privatized and deregulated. Privatization would realize the ownership effect; deregulation the competition effect. Either would be better than the status quo; implementing both strategies would yield the greatest social benefits.

Other Issues

Two kinds of social concern may require attention in a post-reform world. First, reform may jeopardize universal service; second, reform may lead to competition policy concerns in some markets.

Canada Post's general revenues at present fund the universal service obligation to the extent that it is indeed a net cost. In the event of privatization and deregulation, Canada Post would expect to earn a normal rate of return in the markets in which it competes, potentially leaving it unable to service markets costing more to serve than they generate in revenue. The universal service framework, as it presently exists, would potentially be in jeopardy.

In our view, abolishing the current universal service policy infrastructure would be a positive development, whether or not universal service itself is socially meritorious. At present, any subsidy to fund universal service is obscured within the general accounts of Canada Post. It would be an advance to shift to a transparent system of explicit subsidies to promote universality, which would encourage clear debate over the scope of the obligation. Should it exist at all? Should customers expect identical service in sending mail to remote or underpopulated areas as exists in metropolitan areas? Creating explicit subsidies for universal service would reveal costs to the public and inform debate on the optimal approach. Rather than presenting a compelling argument against reform, universality concerns provide further support for change.

A second concern in a post-reform world is that some markets may not be conducive to competition. For example, thinly populated areas may be able to support only one carrier. In such a context, market power concerns arise. Firms may exploit their positions by charging monopolistic prices[21] to deliver to certain areas. As another example, Canada Post may control some essential facilities, perhaps mailboxes or sorting facilities, to which competitors would want access, but Canada Post may resist.

Different policy options are available in the face of market power. First, it may be optimal not to attempt to fine-tune prices, but rather to ensure that no operator abuses its dominant position. This is the general approach taken to monopoly in Canadian competition policy: high prices as the result of dominance are not subject to antitrust scrutiny, but practices that substantially lessen competition are. The justifications for this approach are that fine-tuning prices is error-prone, and requires a costly, regulatory apparatus.

On the other hand, a second option is to establish a regulator to deal with post-reform concerns about market power in local mail markets or access to essential facilities. As we discuss below, for political reasons we conclude that this latter approach is likely better, at least in the short run, despite its costs.

Market power concerns, we stress, are not a reason to resist reform: market power exists in the present environment. Canada Post indisputably enjoys statutory protection from competition in some kinds of mail, entailing potential social costs. In addition, its rivals have alleged that Canada Post has behaved anti-competitively in otherwise competitive markets, such as overnight courier markets, while relying on the benefits it gets from its statutory monopoly to fund these aggressive strategies. Privatization and deregulation would preclude these complaints. Canada Post could compete freely in any market without allegations that it is depending implicitly on cross-subsidies from monopoly protection.

Managing the Transition

In a recent review of privatization and deregulation in the Canadian telecommunications, electricity and airline sectors, Iacobucci, Trebilcock and Winter (2006) concluded that reforms pursuing efficiency or other social values have too often overlooked political considerations. In electricity in particular, a reform package that made economic sense was undermined by political obstacles to change. In the postal context, we recommend far-reaching reform.

It is important in managing the transition to a competitive, privatized environment to account for political resistance to change. There are two

21 Either to the original customer, or to other postal operators that require the network of the local operator to make final delivery.

predictable potential sources of opposition. First, postal workers will resist reform. Second, the risk of higher prices in some markets might also undermine political enthusiasm for reform. In this concluding section, we consider how to address such potential resistance.

The postal union in Canada has stated their opposition to privatization and/or deregulation (Bickerton, 2006). We have reviewed their reasons for opposition and have concluded that they do not have merit from a principled, social perspective. However, this is not to say that their concerns are not well-founded from the union's perspective. It could well be that competitive pressures would compel the reduction of Canada Post's workforce, or that there would be pressure on wages. Indeed, we would recommend the abolition of restrictions on Canada Post, such as a moratorium on closing unprofitable offices, or impediments to contracting out certain routes or tasks. While these developments are positive from a social perspective in reducing inefficiencies and reducing socially unjustifiable transfers of wealth from postal customers to postal workers, they will predictably and understandably create significant concerns on the part of incumbent postal workers and their union.

One policy option is to press on with a move to unshackled competition in the name of principle, regardless of the self-interest of postal workers. The problem with such an approach is that the postal workers form a potentially powerful interest group that could present an obstacle to reform. In our view, the politically sensible approach is to compromise. Existing postal workers can, and indeed have, organized themselves into an interest group capable of resisting or disrupting change. Potential future postal workers, on the other hand, cannot.

A politically pragmatic approach is to compensate existing postal workers for their welfare losses from reform, but not to account for future losses to would-be workers. The obvious approach here would be either to offer generous packages to workers who lose their jobs, or, probably more feasibly, to rely on attrition to reduce the size of the work force and real wages, if this is what competitive markets require. It should not be overlooked that reform would also potentially allow Canada Post to grow, depending on its success in product markets, including those outside traditional mail services. If existing postal workers are not harmed by reform, they are much less likely to resist it. While this may perpetuate some inefficiencies in the short run, it is better to accept these costs than to risk the reform enterprise altogether.

A policy of attrition would entail two remaining considerations. First, attrition may be costly for Canada Post, and high costs may jeopardize a competitive firm's existence. There are different ways of addressing this concern. It may be that it is not a significant concern at all, given that, for example, it would take entrants time to establish themselves in the market. If it was a concern, competitive deregulation could be introduced on a gradual basis, allowing Canada Post time to adjust its workforce. Alternatively, the federal government could offer time-limited financial assistance to Canada Post for the sole purpose of addressing workforce reduction costs. This last policy is the least attractive, given that it opens up the possibility of workers' lobbying for excessive benefits.

Another issue with attrition is that while existing workers are not harmed by it, the union clearly would be as its dues base shrank. The union might therefore resist reform even in the face of a policy that addresses its workers' concerns. On balance, however, we do not view such resistance as requiring a policy response. If incumbent workers are treated well, the internal governance of the union should be such that the self-interest of union leadership would not be allowed to prevail in opposing change. Moreover, adopting policies that would capitulate to union (not worker) concerns about maintaining historical employment and wage levels would risk seriously undermining reform's benefits.

Concerns about price increases because of market power in local markets also invite political attention. Experience has shown that higher prices, even if reflective of costs and thus efficient and better for the population in the longer run, can create political resistance to reform. Electricity reforms in Ontario, for example, were largely derailed when prices rose to reflect costs. In contrast, technological gains have allowed telecommunications prices to fall along with deregulation; as a consequence, these reforms have proved stable (Iacobucci et al. 2006). If deregulation of postal markets were to result in higher prices, political opposition to reform could result.

As a consequence, it would be sensible politically, if not economically so, to create an oversight apparatus to accompany deregulation. To minimize error and administrative cost, we would recommend a light touch, perhaps the establishment of a complaints bureau where citizens could object to excessive prices in an area or market. Even if the regulator adopted an economically grounded, cost-based analysis in reviewing prices, which may well allow higher prices, the existence of a review board may diminish political concerns about gouging. Such a board could also hear complaints from competitors about inefficient denials of access to essential facilities. Again, the most politically appealing approaches, for example, adopting a policy of not allowing price increases, risks undermining the reform enterprise entirely and thus some risk of unpopularity should be incurred.

A Final Word

If successfully managed, postal reform would bring welcome benefits to Canadians. Privatizing Canada Post would improve its governance, and introducing competition would provide economic discipline that does not at present exist. Residual concerns, such as maintaining a universal service commitment, are better addressed with targeted regulatory schemes, rather than the socially costly combination of public ownership and monopoly that we have at present.

References

Baumol, William, Elizabeth Bailey, and Robert Willig. 1977. "Weak Invisible Hand Theorems on the Sustainability of Multiproduct Natural Monopoly." *American Economic Review*, 67: 350-365.

Berle, Adolph A. and Gardiner C. Means. 1968. *The Modern Corporation and Private Property*. New York, Macmillan.

Bickerton, Geoff. 2006. "Postal Deregulation: Its Impact on Postal Workers and the Response of the Postal Union." Presentation to the 14th Conference on Postal and Delivery Economics, Berne, Switzerland. June.

Campbell, James I, Dieke, Alex Kalevi, and Antonia Niederprüm. 2004. *Main Developments in the European Postal Sector*. Bad Honnef, Wik-Consult.

———. 2006. *Main Developments in the Postal Sector* (2004-2006). Bad Honnef, Wik-Consult.

Campbell, Robert M. 2002. *The Politics of Postal Transformation — Modernizing Postal Systems in the Electronic and Global World*. Montreal and Kingston: McGill-Queen's University Press.

Canada Post. 2005. *Annual Report 2004.* Ottawa, Canada Post.

——— 2005a. 2005 *Corporate Plan and 2005 Capital Budget*. Ottawa: Canada Post.

——— 2006. *Annual Report* 2005. Ottawa: Canada Post.

Crew, Michael A., and Paul R. Kleindorfer, eds. 2003. *Postal and Delivery Services: Delivering on Competition.* Boston: MA, Kluwer Academic Publishers.

------ 2003a. *Competitive Transformation of the Postal and Delivery Sector.* Boston: MA, Kluwer Academic Publishers.

------ 2006. *Progress Towards Liberalization of the Postal and Delivery Sector*. New York, NY: Springer.

De Alessi, Louis. 1980. "The Economics of Property Rights: A Review of the Evidence." *Research in Law and Economics* 2:1.

Economic Council of Canada. 1986. *Minding the Public's Business*. Ottawa: Minister of Supply and Services Canada.

Ecorys Research and Consulting. 2005. *Development of Competition in the European Postal Sector*. Rotterdam.

Finger, Matthias, and Patrick Mollet. 2005. *Competitive Analysis of Incumbent Postal Operators in Europe.* Ecole Polytechnique Fédérale de Lausanne, Switzerland.

Geddes, Rick. 2003. *Saving the Mail: How to Solve the Problems of the US Postal Service*. Washington DC: The AEI Press.

——— 2004. "Postal Reform." *Econ Journal Watch* 1: 61-81.

Hrab, Roy. 2003. "Privatization: Experience and Prospects." Research Paper No. 22, Panel on the Future of Government in Ontario.

Hudgins, Edward L., ed. 2000. *Mail @ the Millennium: Will the Postal Service Go Private?* Washington DC. The Cato Institute.

Iacobucci, Edward, Michael Trebilcock and Ralph Winter. 2006. "The Canadian Experience with Deregulation." *University of Toronto Law Journa*l 56: 1.

Jensen, Michael C., and William H. Meckling. 1976. "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" *Journal of Financial Economics* 3: 305.

Jones, Leroy P. 1991. "Performance Evaluation for State-Owned Enterprises" in Ramamurti, Ravi and Raymond Vernon, eds. *Privatization and Control of State-Owned Enterprises*. Washington DC: The World Bank.

Megginson, William L., and Jeffrey M. Netter. 2001. "From State to Market: A Survey of Empirical Studies on Privatization" *Journal of Economic Literature* 39: 356.

New Zealand Post. 2006. *Annual Report 2006*. Wellington.

——— 2006. Fast Facts, online at: http://www.nzpost.co.nz/Cultures/en-NZ/AboutUs/MediaCentre/FastFacts/

Niskanen, William A., ed. 1971. *Bureaucracy and Representative Government*. Chicago: Aldine-Atherton.

Panzar, John C., and Robert Willig. 1977. "Free Entry and the Sustainability of Natural Monopoly." *Bell Journal of Economics* 8: 1-22.

———, John C. 1994. "The Economics of Mail Delivery" in Sidak, J. Gregory, ed. *Governing the Postal Service*. Washington DC: AEI Press 1.

Priest, George. 1975. "The History of the Postal Monopoly in the United States." *Journal of Law and Economics.* 18: 33.

Radwanski, George. 1996. *The Future of Canada Post Corporation — Report of the Canada Post Mandate Review*. Ottawa: Government of Canada.

Royal Mail, Annual Reports from 2002-03 through to 2005-06, available online at: http://www.royalmailgroup.com/portal/rmg/content1?mediaId=23300508&catId=23300505.

Shirley, Mary M. et al. 1995. *Bureaucrats in Business: The Economics and Politics of Government Ownership.* Washington, DC: World Bank.

Smith, Andrew C., and Michael J. Trebilcock. 2001. "State-Owned Enterprises in Less Developed Countries: Privatization and Alternative Reform Strategies." *European Journal of Law and Economics.* 12: 217.

Stevens, B. 1992. "Prospects for Privatization in OECD Countries." *August National Westminster Bank Quarterly Review* 2.

Trebilcock, Michael, J, D.G. Hartle, J.R.S. Prichard and D.N. Dewees. 1982. *The Choice of Governing Instrument*. Ottawa: Ministry of Supply and Services.

———, and J. Robert S. Prichard. 1983. "Crown Corporation: The Calculus of Instrument Choice" in Prichard, J. Robert S., ed. *Crown Corporations in Canada: The Calculus of Instrument Choice.* Toronto: Butterworths.

———, and Edward M. Iacobucci. 2003. "Privatization and Accountability." *Harvard Law Review* 116:1422.

Universal Postal Union. 2002. *The Postal Market in the Age of Globalization.* Berne, Switzerland.

——— 2004a. *Postal Market 2004: Review and Outlook*. Berne, Switzerland.

——— 2004b. *The Future of the Postal Sector in a Changing Global Environment*. Berne Switzerland.

NOTES

NOTES

The C.D. Howe Institute

The C.D. Howe Institute is a national, nonpartisan, nonprofit research organization that aims to improve Canadians' standard of living by fostering sound economic and social policy.

The Institute promotes the application of independent research and analysis to major economic and social issues affecting the quality of life of Canadians in all regions of the country. It takes a global perspective by considering the impact of international factors on Canada and bringing insights from other jurisdictions to the discussion of Canadian public policy. Policy recommendations in the Institute's publications are founded on quality research conducted by leading experts and subject to rigorous peer review. The Institute communicates clearly the analysis and recommendations arising from its work to the general public, the media, academia, experts, and policymakers.

The Chairman of the Institute is Tim Hearn; William B.P. Robson is President and Chief Executive Officer.

The Public Services Papers

For many Canadians, the modern welfare state is a source of civic pride and part of our cultural foundation. The public institutions that comprise the modern state, however, face a continuing fight to retain their legitimacy amid a changing social ethos, and must respond to the fiscal pressures of a globally competitive political, economic, and cultural environment. In turn, Canadians must examine the public sector's interaction with society at large, to ensure that the nation remains a strong and innovative society where equity and entrepreneurship are valued principles.

With the advisory assistance of Michael Trebilcock, University Professor of Law and Economics at the Faculty of Law, University of Toronto, the Public Services Papers will explore the role of markets and market-like forces in the delivery of public services. The aim is to position Canada as a truly competitive democracy; one that provides public services ranking with the world's best, in a fiscal framework that supports Canada's competitiveness and growth. This research series will describe how Canadians may maintain and enhance public service delivery in the twenty-first century.

C.D. Howe Institute
67 Yonge Street Suite 300
Toronto, Ontario
M5E 1J8