

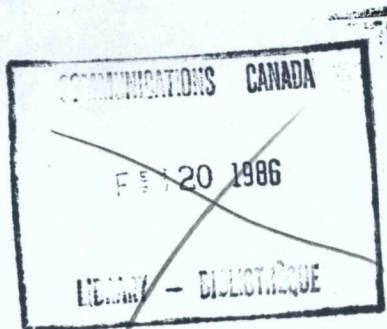
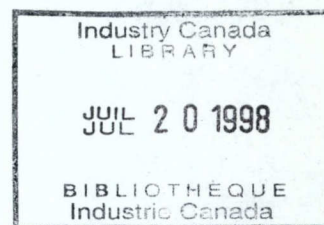
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② THE EFFECTS OF POSTAL SUBSIDY REDUCTIONS ON MAGAZINE PUBLISHERS:
EXAMINATION OF THE U.S. EXPERIENCE

① By Lawrence Olson and Sheldon Hines

Coopers & Lybrand

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PREFACE

This document reports the results of a study performed for the Canadian Communications Ministry, under a subcontract by Coopers & Lybrand in the U.S. with Currie, Coopers & Lybrand in Canada. The study draws heavily on three earlier studies performed for the U.S. Postal Service -- two Data Resources, Inc. studies that were directed by Dr. Olson and a Coopers & Lybrand study in which Mr. Hines served on the project team. We would like to thank the Magazine Publishers Association and the associated Publishers Information Bureau, as well as Rose Marie Zurmco Bratland of the U.S. Department of Commerce, for their help in finding data.

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Introduction

This study examines the response of the U.S. magazine publishing industry to reductions in postal subsidies since the Post Office Department became the U.S. Postal Service in July 1971.

The same law that created the U.S. Postal Service -- the Postal Reorganization Act -- required that postal subsidies for magazines be substantially reduced. The magazine publishing industry, nonprofit organizations, and other highly vocal groups predicted that the reduction in subsidies would lead to tremendous increases in delivery costs -- too great for many publications to handle.

Postal costs borne by publishers did rise substantially over the period since 1972, and this change occurred simultaneously with rising costs in other areas such as paper and energy and with increasingly tough competition for advertising dollars. Our results show, however, that U.S. magazine publishers have proved equal to the challenge. Through cost reducing programs and various efforts to improve the value of their offerings to customers, the industry has actually emerged from the difficult recent period stronger than at its beginning -- with more magazines being published, increased total circulation, and higher before-tax operating profits.

One can only speculate about what would have happened without reductions in postal subsidies. It is clear now, however, that the reductions did not destroy the ability of publishers to serve the information needs of the American public, did not lead to widespread magazine publisher bankruptcies, and did not compromise the general quality of service given to readers and advertisers.

The Economics of U.S. Magazine Publishing

Periodical publishing in the U.S. is a highly competitive industry composed of over 11,000 firms, most with staffs of less than twenty people. It is traditional to characterize magazines as belonging to one of three major groups -- consumer, business, and farm publications. Consumer publications are responsible for about three-fifths of total receipts, while the fast-growing business segment accounts for about one third of revenues.

The magazine industry gets revenues from two sources, advertisers and consumers. Advertising provides far greater revenues than sales to

consumers. In selling to consumers, publishers obtain far more revenue from subscriptions than from single-copy or newsstand sales. ^{a/}

In the consumer side of the business, the publisher has a choice about where to focus sales efforts. Direct mail advertising techniques are clearly more suitable for inducing subscription sales and for reaching valuable targeted subscriber groups that such sales can generate, than for inducing newsstand sales. Newsstand sales are dependent on impulse purchases by consumers, and are subject to highly seasonal demand, making these sales historically more volatile than subscriber sales, and thus less useful as a revenue generator. Furthermore, the number of newsstands is decreasing. Both types of sales compete with a range of other sources of information and entertainment, including newspapers, radio, television, and books.

The advertising side of the business is perhaps even more competitive than the consumer side, although since ad rates depend on the size and demographic "quality" of subscription and newsstand sales, the two parts are obviously intertwined. ^{b/} Magazine sales of ad space compete with various other advertising media, including mail order, television, radio, newspapers, and newspaper inserts. All of these alternative media have become more sophisticated over the past ten or so years, with the greatest advances probably occurring in direct mail and newspaper inserts, followed by television. Despite this heavy and increasing competition, the rising importance of advertising expenditures in the economy and the agility shown by publishers in competing have kept magazine advertising revenues growing.

One element of the response to magazine publishers' rising costs and rising competition has been a strong move toward specialization in magazines -- away from general interest publications such as Time, Reader's Digest, and Playboy, and toward more focused publications such as Byte, Runners World, and Scientific American. This move toward specialty magazines capitalizes on improvements in direct mail targeting, creates a somewhat more loyal and predictable circulation base, and facilitates higher ad rates by providing a better-characterized population for advertisers. For example, even Time and Newsweek have moved somewhat in this direction, by providing a few "localized" ad pages that contain different copy in different local areas, and some business publications offer special editions for top business executives.

Changes in the U.S. Legal and Regulatory Environment Affecting Postal Rates and Subsidies

Prior to establishment of the Postal Service in July 1971, postal rates for second class (periodical and newspaper) mail were set by the Congress. Congressional committees held hearings on postal rate changes proposed by the Post Office Department. The committee members and their staff evaluated

^{a/} See Data Resources, Inc., "Magazine Publishing and Mail Volume: Trends and Implications," 1982.

^{b/} See Data Resources, Inc., "Trends in Advertising: Implications for the U.S. Postal Service," 1981.

testimony from Post Office officials, postal patrons, and Post Office competitors. The committees voted on recommended rate changes, and sent reports on rate recommendations to the full House and Senate for further deliberation and voting. Ultimately, the Congress sent legislation to the President for signature.

The proceedings before the committees were relatively informal, and committee members appear to have determined postal rates as much on the basis of political expediency as on the weight of evidence. Members of the committees that deliberated on postal rates were subject to special influence from constituents and from contributors to their political campaigns.

In 1968, a blue ribbon panel appointed by President Johnson (the Kappel Commission) recommended that an independent commission similar to the Interstate Commerce Commission be established to hold formal hearings on postal rate changes and recommend changes in rates to the Board of Governors of the proposed new Postal Service. The aim of this proposal was to make rate hearings subject to U.S. administrative law (including strict rules of evidence and cross examination of witnesses), as well as to remove the proceedings from the realm of politics and the pleadings of special interest groups. The Postal Reorganization Act authorized the establishment of this commission, called the Postal Rate Commission, which came into existence in July 1971.

Prior to 1971 there were only imprecise measures of the subsidies being provided to particular mail classes. Only in the late 1960s did the Post Office Department develop a sophisticated cost ascertainment system to measure postal costs attributable to particular classes of mail. Both unit cost estimates and volume estimates were subject to red pencilling by Post Office management. It was not clear to what extent different mail classes and subclasses were subsidized. Furthermore, in establishing postal rates, the Congress did not base them on reported attributable cost levels.

The Postal Reorganization Act provided strict guidelines for the provision of postal subsidies. Only certain categories of mail were to continue to receive a subsidy, that is, a preferred rate below the attributable cost of handling that category of mail. Preferred rates were authorized for newspapers and magazines intended for distribution within the county of publication and for nonprofit, classroom, agricultural, and small circulation publications. The difference between costs and rates for these categories of mail was to be funded by a Continuing Appropriation. Congress also authorized a Phasing Appropriation to ease the transition from heavily subsidized rates to the new cost-based rates. The latter subsidy applied at first both to regular rate second-class categories and preferred rate second-class categories. (Currently, only preferred rate categories receive a Phasing Appropriation; this will expire in Fiscal Year 1986.)

The Postal Rate Commission and the Postal Service Board of Governors are prevented by law from accepting special pleadings from mailers or competitors of the Postal Service, except in open hearings in which all interested parties are free to participate. However, mailers and competitors to the Postal Service have continued to direct special pleadings to the Congress. In fact, in 1974 the Congress voted to extend the phasing period for preferred rate categories from 10 to 16 years and regular rate categories from 5 to 8

years. However, there is no discrimination in application of postal rates between mailers, and no publication receives subsidies from the government except through preferred postal rates available to any authorized mailer.

Mailers and competitors to the Postal Service have also used the courts in attempts to change the method of measuring attributable costs, to change the methods used by the Rate Commission to allocate overhead costs to specific mail categories, or to overturn specific rate increases recommended by the Rate Commission and adopted by the Board of Governors. Each omnibus rate decision since 1972 has been appealed to the Federal courts. No decision has ever been overturned, although one decision made by the courts in favor of the trade association representing the greeting card industry resulted in major changes in the level of attribution of postal costs to specific mail classes.

Trends in Postal Subsidies and Costs

One of the greatest cost shocks suffered by U.S. magazines during the past 15 years has been the gradual reduction of postal subsidies and increases in postal rates for second class mail. As Table 1 shows, appropriations made by the Congress to the Postal Service specifically for second class mail rate subsidies dropped from \$236 million in fiscal year 1972 to only \$156 million in fiscal year 1984. Since volume was increasing during that period, appropriations per piece were falling even faster than total appropriations. The implicit deflator for personal consumption expenditures (a broad, general price index) and the current price index increased by factors of 2.23 and 2.49 respectively over this period, so real (inflation-adjusted) appropriations per piece fell to a small fraction of their 1972 level. In short, for most magazine publishers, subsidies went from being a key factor in moderating publishing costs in 1972 to a much less important factor in 1984.

Table 2 tells a related story -- the increase in postal revenues per piece for magazines between 1973 and 1978. Postal rate increases over this period reflected both decreasing subsidies and increasing postal costs (subsequent increases have been more moderate). On net, however, real postal costs for magazine publishers rose rather steeply. The declining subsidies had a major role in those increases.

Finally, Table 3 shows changes in postal costs as a percentage of total operating costs. As expected, these percentages are generally higher (although still quite volatile) in recent years than in earlier years. Total postal costs to commercial publishers rose from an average of around 8.5 percent of overall costs in the early 1970s to around 10 percent in the early 1980s, with most of that change occurring in second class postage. The moderate rise in the share of third class costs partly reflects the increased intensity with which more specialized magazines are using direct mail advertising. The advent of the bulk rate (presort) third class mail classification in the 1970s has acted to reduce the effects of rising third class rates on publishers' third class costs.

The rise in the cost share of postal costs to commercial publishers is rather moderate, given the large declines in subsidies and increases in postage per piece shown in Tables 1 and 2. This reflects substantial increases in other publishing cost items, notably paper, energy, and (to a lesser extent) other transportation expenses, machinery, and labor. Thus,

postal costs increased more rapidly than operating costs in general, but most of the total dollar amount of magazine cost increases came from items other than postage.

Magazine Publishers' Responses to Market and Competitive Challenges

The publishers' dilemma was clear, then. How could they respond adequately to the twin challenges of rising costs -- especially postal costs that hit directly at their key subscription base -- and toughening competition in advertising? How indeed? In fact, there were numerous predictions of widespread business failures among publishers during the early to mid-1970s. One example was the report "An Assessment of the Impact of Increased Second Class Postal Rates on the Magazine Industry," by Richard Barber Associates, Inc. for the Magazine Publishers' Association, March 26, 1973.

The perhaps surprising answer is that the commercial magazine publishers responded rather well.

- The number of magazines has risen steadily (see Table 4.)
- Average (total) circulation per issue has also risen steadily (this is defined as the total circulation of an average monthly Reader's Digest, plus the total circulation of an average weekly issue of Time, and so on through all magazines covered by the Audit Bureau of Circulation). (See Table 5.)
- From 1972 to 1978, the newsstand share of circulation increased, reflecting restricted subscription circulation increases related to rising postal costs. As the trend toward specialization took hold, however, there was a renewed emphasis on subscription circulation. The subscription share now stands six percentage points above its 1972 level and nine points higher than its nadir in 1976 through 1977.
- In a related trend, the advertising share of revenues first fell with increased competition and a declining subscription share of circulation, and then rebounded to approximately its 1972 level (see Table 6).
- Publishers increased their efforts to deliver subscription copies of magazines through local delivery firms and newspapers; the latter made final delivery to designated postal zones or specific routes established within a zone. This effort to develop an alternate delivery industry reached its greatest momentum between 1978 and 1980, just following the most rapid increases in postal rates. By encouraging the development of an alternate delivery industry, publishers hoped to prove that unchecked postal rate increases could result in the Postal Service losing the cream of the magazine delivery market. The alternate delivery firms, however, never delivered more than a tiny percentage of all magazines, and since 1980 the alternate delivery industry has practically ceased delivering national magazines. This has been due both to moderating postal rate increases since 1980 and to the growing importance of presort discounts for second class first begun in 1978. The latter have especially benefited the publishers of the large magazines who had been the most vocal proponents of the use of

alternate delivery firms. ^{c/} Furthermore, alternate delivery firms proved unable to effect final delivery to all addresses in a given postal zone, thereby causing logistical difficulties for publishers.

- Publishers instituted a range of management, product, and marketing changes over the period in an attempt to escape the cost/competition bind described above. These included reductions in trim size ^{d/} (see Table 7), use of somewhat lighter papers, and holding employee wage increases below the rate of inflation. Significant price increases occurred despite these cost reduction efforts, but magazine publishers simultaneously appear to have provided higher-value services to readers and advertisers, thereby in some sense mitigating the higher advertising rates and subscription prices. These efforts to improve value have included increased attention to editorial quality, redesigned graphics, and a tighter focus on policy issues considered important by the readership. For advertisers, these efforts have included closely targeted mail campaigns to increase the numbers of "upscale" or special market readers, improved layouts and ad design capabilities, and an increase in inserts and other methods aimed at ensuring that ad copy actually gets read by readers.
- Profits responded well to the cost reduction and value enhancement efforts of publishers. As Table 8 shows, before-tax operating profits (total revenues minus total costs) more than doubled, from 5.65 percent in 1972 to 11.29 percent in 1982, indicating success in increasing revenues faster than costs during that period.

In summary, magazine publishing has met the challenges of higher postal rates, as well as other pressures of costs and competition. The industry continues to be highly competitive internally, but it is a stronger and more economically viable entity now than in past decades, and better able to meet any new challenges that may arise.

It is difficult to say whether the industry would be appreciably better off today if postal subsidy reductions had not occurred. On the one hand, costs would be lower, thus allowing either lower prices and higher ad and circulation sales or higher profits at the same sales levels. On the other hand, publishers would have faced less of a challenge over the past 13 years, and might have been less diligent in their efforts to cut costs and improve the value provided to customers.

^{c/} Presort discounts offer the greatest savings for mailings destined to postal zones where the ratio of subscribers per postal route is relatively high. Such mailings represent the cream of the magazine delivery market. They are the cheapest to deliver and were the only kind of mailings the alternate delivery industry could deliver at competitive rates in the late 1970s.

^{d/} Trim size is defined as length of a page times width of a page.

Our best guess is that the cost and competitive challenge would have been strong enough even without rising postal rates, and that publishing would therefore be in an even stronger position today if rates had not risen. In any event, and whether or not this guess is correct, the industry has shown an ability to respond to a challenging period.

TABLE 1

TOTAL APPROPRIATIONS FOR SECOND CLASS AND CONTROLLED CIRCULATION MAIL a/
(\$ millions)

<u>FISCAL YEAR</u>	<u>TOTAL APPROPRIATIONS</u>
1972	236.0
1973	252.5
1974	246.0
1975	285.3
1976	335.4
Transition Period <u>b/</u>	92.8
1977	349.1
1978	309.0
1979	271.0
1980	173.9
1981	164.6
1982	162.2
1983	193.8
1984	156.4

Source: U.S. Postal Service

a/ These categories of mail include magazines of commercial publishers, magazines of nonprofit organizations, and local and national newspapers.

b/ The transition period was July-September 1976. Fiscal years since 1977 have ended in September.

TABLE 2

CHANGES IN POSTAL REVENUES PER PIECE
FOR MAGAZINES BETWEEN JULY 1973 AND JULY 1978 a/

	Revenues at July 6, 1973 Rate Level <u>b/</u> (\$ thousands)	Revenues at July 6, 1978 Rate Level <u>c/</u> (\$ thousands)	Percent Change
Inside County	1,543	2,856	85%
Outside County	108,150	405,203	275%
Total	109,693	408,059	272%
Revenue per Piece <u>d/</u>	0.030343	0.112876	272%

Source: Coopers & Lybrand, Study on Competition in Component Markets of the Mailstream, Volume II, June 1980, p. II-C-40.

a/ Revenues at both rate levels are derived by applying then-current rates to volumes for fiscal year 1978. Since volume is held constant, the change in revenues between the two rate schedules is equivalent to the change in average rates over the five-year period. The revenues at July 6, 1978 rate levels are not the same as FY 1978 revenues, since several rates schedules were in effect in that fiscal year.

b/ Rates in effect from July 6, 1972 until September 9, 1973.

c/ Rates in effect from July 6, 1978 until July 6, 1979.

d/ Total pieces for FY 1978 (in thousands): 3,615,105.

TABLE 3

POSTAL COSTS AS A PERCENTAGE OF
MAGAZINE PUBLISHERS' OVERALL COSTS a/

	<u>First Class</u>	<u>Second Class</u>	<u>Third Class</u>	<u>Total</u>
1972	1.83	5.29	2.05	9.17
1973	1.83	5.07	1.67	8.67
1974	1.53	5.60	1.53	8.66
1975	1.65	5.15	1.24	8.04
1976	2.17	5.47	1.34	8.98
1977	1.64	5.66	1.58	8.88
1978	1.45	6.51	1.56	9.52
1979	1.36	7.77	1.54	10.67
1980	1.31	8.01	1.59	10.91
1981	1.35	6.83	1.55	9.73
1982	1.51	6.75	2.18	10.44
1983	1.41	6.50	2.26	10.17
1984	1.13	5.95	2.38	9.46

Source: Coopers & Lybrand calculations with
Magazine Publishers Association data

a/ Data come from a survey of Magazine Publishers Association members,
most of which are in the consumer magazine area.

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TABLE 4

GROWTH IN NUMBER OF U.S. MAGAZINES ^{a/}

<u>Year</u>	<u>Number of Magazines</u>	<u>Index (1972=100)</u>
1970	9,573	105.63
1971	9,657	106.57
1972	9,062	100.00
1973	9,630	106.27
1974	9,755	107.65
1975	9,657	106.57
1976	9,872	108.94
1977	9,732	107.39
1978	9,582	105.74
1979	9,719	107.25
1980	10,236	112.96
1981	10,873	119.98
1982	10,688	117.94
1983	10,952	120.86
1984	10,809	119.28
1985	11,090	122.38

Source: Magazine Publishers Association

^{a/} Data refer to all Audit Bureau of Circulation magazines, including both consumer and business publications.

TABLE 5

AVERAGE MAGAZINE CIRCULATION PER ISSUE ^{a/}

<u>Year</u>	<u>Newsstand (%)</u>	<u>Subscription (%)</u>	<u>Total Circulation</u>
1972	32	68	239.1
1973	34	66	243.5
1974	34	66	249.8
1975	34	66	249.9
1976	35	65	254.3
1977	35	65	260.7
1978	35	65	266.2
1979	34	66	268.7
1980	32	68	280.7
1981	30	70	288.8
1982	29	71	297.2
1983	27	73	305.1
1984	26	74	313.6

Source: Coopers & Lybrand calculations with
Magazine Publishers Association data

TABLE 6

SPLIT BETWEEN CIRCULATION AND ADVERTISING REVENUES
FOR ALL MAGAZINE PUBLISHERS

<u>Year</u> ^{a/}	<u>Circulation</u>	<u>Advertising</u>
1972	43%	57%
1977	47%	53%
1982	44%	56%

Source: U.S. Department of Commerce

^{a/} Complete information is available only in "Census of Industry" years, every five years.

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TABLE 7
AVERAGE TRIM SIZE OF 84 SAMPLE CONSUMER MAGAZINES
(square inches)

<u>Year</u>	<u>Level</u>	<u>Index</u> <u>(1970=100)</u>
1970	94.4	100.0
1971	93.8	99.3
1972	92.6	98.1
1973	92.4	97.8
1974	92.7	98.2
1975	91.7	97.2
1976	89.4	94.7
1977	89.1	94.4
1978	88.8	94.0
1979	88.7	93.9
1980	88.6	93.8

Source: Data Resources, Inc., "Magazine Publishing and Mail Volume: Trends and Implications," October 1982, p. 37.

TABLE 8
MAGAZINE PUBLISHERS TOTAL OPERATING COSTS
AS A PERCENTAGE OF TOTAL REVENUE a/

1972	
1973	94.35
1974	91.06
1975	94.30
1976	95.28
1977	93.08
1978	90.40
1979	90.97
1980	92.02
1981	92.23
1982	91.03
1983	91.24
1984	89.11
	88.71

Source: Magazine Publishers Association

a/ Data come from the same survey as was used in Table 3 and refer to Magazine Publishers Association members.