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THE DANGER OF MONOPOLY-SUBSIDIZED PRICING BY THE POSTAL SERVICE IN COMPETITIVE MARKETS

Executive Summary

Federal laws grant the Postal Service, an arm of the government, monopolies on non-urgent letter delivery and access to mailboxes. If not carefully regulated, the Postal Service could abuse those dual monopolies by charging very high prices to consumers within its sheltered market. To provide some protection, the Service must seek approval from another, independent federal agency, the Postal Rate Commission (PRC), before changing its products' prices.

The Postal Service also operates in many non-core markets that are not shielded by its monopolies and in which it faces vigorous competition from private-sector businesses. The Postal Service's prices in those markets are generally also subject to regulatory oversight.

The Postal Service has long argued that current price regulation is too burdensome and should be loosened. A natural concern, however, is that less regulation of core products would increase the danger that the Service would abuse its monopoly power. It might seem at first glance, though, that little pricing supervision is needed in markets where competition protects customers against excessively high prices. In fact, careful regulatory oversight is also needed there. The danger in competitive markets is that the Service will cause damage by setting prices that are ***too low***.

Whereas private-sector businesses try to avoid predatory pricing because it hurts profits, there are strong incentives at government-owned entities to push prices too low in competitive markets to fuel expansion.

If a government enterprise like the Postal Service is not prevented from underpricing its competitive-market products, the agency will hurt itself financially, and its captive-market customers will likely suffer as the agency tries to compensate by raising prices where it has monopoly power. Taxpayers will be injured if the low prices lead to a taxpayer bailout, and government revenue collections will weaken as taxpaying businesses are displaced by the tax-exempt Postal Service. Given the relative inefficiency of government agencies, Postal Service expansion in competitive markets will also damage the economy's productivity.

One reason the Postal Service gives for demanding more rate-setting flexibility is that the rate-setting process is slow and cumbersome. However, the Service has ignored or resisted many ways to speed up and improve the rate setting process that would still maintain prudent safeguards.

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Magic acts often rely on misdirection: while audience members' eyes are drawn to the conspicuous movements of one of the magician's hands, they fail to notice what the magician is doing with his other hand. An illusion worthy of a magic act frequently clouds discussions of whether the prices charged by the Postal Service for its products need to be regulated as much as they are today.

The Postal Service, which is part of the federal government, does most of its business in a core market where federal laws shelter it from competition. Laws known as the private express statutes[1] give the organization a monopoly on the hard-copy delivery of non-urgent letters, and another federal statute[2] provides it with a "mailbox monopoly" by granting it exclusive access to people's mailboxes. By virtue of these dual monopolies, the government enterprise possesses great market power within a core market consisting primarily of the hard-copy delivery of non-urgent letters and periodicals. A legitimate concern is that the Postal Service may abuse its power by charging captive ratepayers excessively high prices. To try to prevent that from happening, it is only prudent to have an independent regulator that closely and vigorously oversees the prices of the Postal Service's monopoly-market products. Congress established an independent federal agency, the Postal Rate Commission (PRC), and entrusted it with that responsibility.

The Postal Service also operates in a number of non-core markets, such as express mail, package delivery, greeting cards, and money transfers, where it does not have a monopoly, its market share is small, and private-sector businesses in those markets provide it with strong competition. The PRC regulates the prices the Postal Service charges on most of its products in these markets.

Customers, of course, do not need a regulator to protect them from high Postal Service prices in non-core markets. Competition does that job. If the Postal Service charges too much for a competitive-market good or service, customers can turn to one of the private-sector companies offering a similar product. Would it be safe, then, to regulate only lightly the Postal Service's prices in competitive markets?

This notion often appears in discussions of possible legislative reform of the Postal Service. The argument begins by recognizing that the Postal Service can harm customers within its core, monopoly market by charging monopolistic prices. The argument proceeds by noting that while regulation is needed to prevent excessive prices in the agency's core market, competition guards against high prices in the agency's non-core markets. Therefore, the argument concludes, it would be safe to let the Post Service set prices as it wishes in competitive markets.

Although this line of reasoning may seem plausible at first glance, it is based on misdirection. The misdirection is not the work of a magician, but comes from thinking in terms of the Postal Service's monopoly market when considering where the pricing danger lies. In the Postal Service's monopoly market, the threat is that the Postal Service will seek prices that are ***too high***, injuring its core customers. In competitive markets, however, careful regulation is needed to prevent the Postal Service from causing damage by setting prices that are ***too low*** compared to costs, injuring the competition and threatening its own finances, which may require a future rate hike on its core customers and maybe a taxpayer bailout.[3]

Low prices can cause trouble. If Congress significantly relaxes regulatory oversight in competitive markets and the Postal Service uses that pricing flexibility to charge very low prices in those markets, how could that do any harm?

One problem is that if the Service sells a competitive-market product for too little, it will lose money on the product. (If the Service is already losing money on the product, a lower price will probably widen the loss.) The red ink will hurt the Postal Service financially. It will also hurt core-market ratepayers because they will probably have to pay higher rates to help offset the loss. Taxpayers may be harmed, too, because Congress may authorize a taxpayer bailout if the Service's competitive-market losses due to very low prices grow large enough to threaten the Service.

The Postal Service can almost certainly increase its volume in competitive markets by lowering its prices there. But remember that the Service is a government enterprise. If it is less efficient than private-sector producers, which is often the case with government enterprises, it will reduce the economy's productivity and vigor when it takes over production that had formerly occurred in the private sector.

Further, because the Service has many governmental powers and privileges and carries those indirect subsidies into its competitive market operations, its presence in those markets raises fairness issues. When the Postal Service displaces private-sector companies, federal, state, and local tax revenues fall, and must be made up by raising taxes on other parties. Private-sector companies must pay income taxes, property taxes, gross receipts taxes in some jurisdictions, collect sales taxes, pay motor vehicle registration and licensing fees, obey zoning rules, obey the antitrust laws, and are expected to pay their investors competitive rates of return. By contrast, the Postal Service is exempt from income taxes, exempt from property taxes on properties it owns, exempt from gross receipts taxes, does not have to collect sales taxes, is exempt from vehicle registration and licensing fees, is not required to obey zoning laws, has sovereign immunity from the antitrust laws, can obtain cut-rate loans at the U.S. Treasury, and has various other governmental privileges. In addition to its drain on government coffers, its exemptions and other advantages are unfair to private-sector businesses against which it competes.

One might hope that the unhealthy effects of its competitive-market activities would be enough to deter the Postal Service from pushing the prices of its competitive-market products too low. Real-world experience teaches, however, that government entities often seek to enlarge their size and sphere of influence whether or not doing so is in the public interest. Growth appeals to those within a government agency because it brings them greater power, prestige, and other bureaucratic rewards. In an economic and legal analysis comparing the rewards, penalties, and restrictions facing state owned enterprises (SOEs) and private-sector companies, researchers David Sappington and J. Gregory Sidak reached similar results. They concluded that a government enterprise has a "greater incentive and ability to price below cost" than does a private-sector business.[4] Hence, if the Postal Service is given more leeway over the prices of its competitive-market products, those within the organization would face strong incentives to push down prices in order to pump up volumes. (The Service would not be similarly inclined to cut prices within its monopoly because those are the products on which it is most dependent for revenues and because lower prices in its captive market would not lead to much of an increase in sales there.)

To be sure, the current Postmaster General, John Potter, has accomplished something rarely seen at the Postal Service or other government agencies: he has significantly reduced the workforce (through attrition and buyouts), which has produced cost savings, productivity gains, and financial improvement. One might be less concerned that the Postal Service would abuse pricing discretion in non-core markets if assurance could somehow be given that the Postal Service will always behave in the future as it is acting now. Unfortunately, no such assurance is possible. For instance, Postmaster General William Henderson, who preceded Mr. Potter, declared, "E-commerce is a passion of mine,"[5] and thought the Postal Service should try to become one of the major commercial presences on the Internet. After heavy losses and much criticism, the Postal Service has now abandoned most, but not all, of its e-commerce ventures.[6] Mr. Henderson was a model of restraint, though, compared to the Postmaster General before him, Marvin Runyon, who repeatedly demanded that the Postal Service greatly expand its competitive-market operations while retaining all its government-based powers and privileges. In general, it is not unusual to find that a government agency exhibits financial restraint one year but is financially reckless several years hence. Loosening the regulatory oversight of the Postal Service's competitive-market products would be an invitation for trouble.

A bad deal for monopoly-market customers that gives the illusion of being a good deal. It is sometimes thought that core-market customers can protect themselves by cutting a deal: Let the Postal Service set the prices of its competitive-market products pretty much as it wishes but, in return, make it promise not to raise the prices of its core products faster than the rate of inflation. In Congressional hearings this year, several mailers caught within the Postal Service's monopoly market suggested such a trade.[7] They testified that postage is one of their main expenses, that rate increases hurt them, and that they would gladly agree to a revised system of rate regulation if it limits postal price hikes to no more than the rate of inflation. While the concern of mailers is understandable, the reality is that a promise to limit postage increases to the inflation rate would provide little protection because, when push came to shove, it would be politically unenforceable.

To see the problem, suppose the deal is made, but the Service later finds that because of cost-control problems, its expenses are increasing faster than the inflation rate. Holding the Service to the rate cap would then push the agency ever deeper into the red. In a study prepared for the bipartisan President's Commission on the U.S. Postal Service, Robert Reisner of Global Insight warned that if tight price caps are imposed without effective constraints on wage increases (wages are 75%-80% of the Postal Service's costs), the effect on the Postal Service's solvency could be analogous to what happened to California electric utilities following that state's botched attempt at regulatory reform.[8] The losses would directly violate a key postal reform guideline enunciated by the Administration: the U.S. Postal Service should be "financially self-sufficient, covering all of its obligations."[9] Assuming the Administration is not willing to abandon this principle and Congress is not willing to let the Postal Service go out of business, the Service would at that point have to be permitted to raise core-product postal rates faster than the inflation rate. When that happens, core-market mailers should be concerned that if the Postal Service is allowed to set the prices of its competitive-market products as it wishes, the Service will try to hold down price increases there and compensate by increasing the prices of its monopoly-protected products more quickly than otherwise. Mailers should also be worried that the Postal Service might come to regard the inflation rate as a price floor rather than a price cap. The message here is that effective cost management, not revamped rate regulation, is the key to an economical Postal Service that provides reasonable service.[10]

Cut-rate pricing is a bad business strategy for a high-cost producer. Another misperception is that the Postal Service could somehow ease its financial woes by pricing aggressively in competitive markets to push up sales revenues there. In this view, regulatory barriers to low prices on non-core products are holding back a healthier bottom line. The reality, however, is that while aggressive pricing can be an excellent business strategy for a low-cost producer, it is a ruinous strategy for a high-cost producer. Again, to improve its bottom line, the Postal Service needs to manage its costs better, not tinker with product prices.

If the Postal Service would cooperate, pricing could be more flexible while maintaining prudent regulatory oversight. While portraying the current regulatory system as a straightjacket that must be removed, the Postal Service ignores or resists a number of practical methods for speeding up the current regulatory system with its consumer safeguards. For instance, PRC Commissioner Ruth Goldway suggested that if the Service thinks the price of a particular product is out of line, the Service file a niche classification case or a narrowly focused rate case that the PRC could handle quickly. The Service, she noted, generally "fails to mention that it can file" such cases under current law.[11] Commissioner Goldway also suggested "separating rate cases from methodology and classification cases. Such a reform [using pre-agreed-upon cost-measurement rules and not seeking to change classifications during rate cases] might make ratemaking into a fairly quick exercise of plugging updated cost data into a formula."[12]

In the *Transformation Plan* study it released in April 2002, the Postal Service pointed to another area where it thinks it has pricing flexibility under current law, but has never sought to use that flexibility. The issue is whether it could quickly adjust postal rates in response to significant and unexpected changes in fuel costs "Perhaps under current law, the Postal Service could propose ... [an] energy price inflator on mail categories where transportation costs are a significant portion of the attributable costs... The law would presumably allow this type of adjustment if supported with compelling cost evidence."[13] Given that the Service has often complained about the difficulty of having to cope with unexpected increases in operating costs due to higher fuel prices, it is puzzling that the agency has not explored this current-law option for greater pricing flexibility.

As another example of a neglected opportunity under current law, Postmaster General Potter, while testifying before a joint Congressional hearing, called for a revamped rate-regulation system that would permit rate increases to occur "in smaller, annual increments that can be absorbed by our commercial customers" rather than the large, irregular increases that have occurred in the past.[14] But if smaller, more regular rate increases are the goal, why hasn't the Postal Service asked the PRC to approve rate increases that occur in multiple steps? Phased-in rate increases appear to be permitted under current law, with perhaps modest changes in PRC regulations, if the Postal Service would only request them.

To cite one more promising avenue for streamlining the rate-setting process, the Postal Service could provide more information regarding costs, revenues, and measurement methodologies in its periodic reports so that when rate cases were later filed, the PRC would already have seen and analyzed much of the needed data. The PRC took the first step in this direction in 2003 by proposing that the Service be required to provide greater information in future periodic filings.[15] The Postal Service, though, strongly opposes this initiative, even though it would speed up future rate cases.[16] If the Postal Service's objective is a well functioning rate setting process, not simply a rollback of regulatory supervision, why does it ignore remedies that appear to be available under current law?

Conclusion. If the Postal Service did not have monopoly powers, there would be no need to worry that it would charge too much to its core customers. Competition (the ability to go to other producers) would protect those consumers. If the Service were not a government-owned enterprise, there would be no need to be concerned about it charging too little to its competitive-market customers. A private-sector company does not want to underprice its competitive-market products because that would reduce its profits. However, since the Postal Service does have a monopoly and is government-owned, careful regulation is vital to protect against the Postal Service setting exploitively high prices within the postal monopoly and excessively low prices in non-core markets.

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Endnotes

1. 18 U.S.C., Sec. 1693-1697.

2. 18 U.S.C., Sec. 1725.

3. Most introductory economics textbooks discuss at length the threat of high prices when a producer has a monopoly, but say relatively little about producers wanting to set excessively low prices when they face competition. (For a good discussion of price and output under monopoly, see, for example, James D. Gwartney, Richard L. Stroup, and Russell S. Sobel, *Economics: Private And Public Choice*, Ninth ed. (Fort Worth, TX: Harcourt College Publishers, 2000), esp. pp. 611-615.) The reason for the difference in emphasis is that most introductory economics textbooks concentrate on production by private-sector companies, and private-sector businesses do not want to set prices that are too low because doing so would hurt their profits. As explained later in this paper, the incentives to seek excessively low prices are most likely to emerge when a producer is, like the Postal Service, owned by the government.

4. David E. M. Sappington and J. Gregory Sidak, "Competition Law for State-Owned Enterprises," *Antitrust Law Journal*, vol. 71, no. 2, 2003, pp. 479-523, quote on p. 485, accessed on the Internet via http://papers.ssrn.com/sol3/papers.cfm?abstract_id=357720. For a more technical economic analysis by the same authors, with many references to prior economic work in the area, see David E. M. Sappington and J. Gregory Sidak, "Incentives for Anticompetitive Behavior by Public Enterprises," *Review of Industrial Organization*, vol. 22, 2003, pp. 183-206, accessed on the Internet via http://papers.ssrn.com/sol3/papers.cfm?abstract_id=269489.

5. Remarks by William J. Henderson, Postmaster General, Delivered at the National Postal Forum, Chicago, Illinois, September 1999, cited in Susannah Zak Figura, "Feeling The Byte," *GovExec.com*, February 2000, originally accessed on the Internet at www.govexec.com/features/0200/0200s.htm. For an analysis written at the time explaining why the Postal Service is not and should not try to become a dot-com, see Michael Schuyler, "The Postal Service Should Keep Its Hands Off E-Commerce," *IRET Congressional Advisory*, No. 105, May 23, 2000.

6. See Michael Schuyler, "Postal Service Cancels Some Electronic And Financial Services Products; Should Cancel More," *IRET Congressional Advisory*, No. 167, March 19, 2004, available on the Internet at ftp://ftp.iret.org/pub/ADVS-167.PDF.

7. For hearings at which some of the witnesses took this position, see Special Panel on Postal Reform and Oversight, Committee On Government Reform, "Answering the Administration's Call for Postal Reform - Pt. III,", February 11, 2004; U.S. Senate Committee on Governmental Affairs, "Postal Reform: Sustaining the 9 Million Jobs in the $900 Billion Mailing Industry (Day 1)," March 9, 2004; and U.S. Senate Committee on Governmental Affairs, "Postal Reform: Sustaining the 9 Million Jobs in the $900 Billion Mailing Industry (Day 2)," March 11, 2004.

8. Robert A. F. Reisner, Global Insight, "Price Caps and the US Postal Service: Prospects, Perils and the Public Interest," Project for President's Commission on the United States Postal Service, 2003, p. 10, accessed on the Internet at http://www.treas.gov/offices/domestic-finance/usps/docs/may_26_paper3.pdf.

9. U.S. Treasury, "Bush Administration Announces Principles for Postal Reform," JS-1044, December 8, 2003, accessed on the Internet at http://www.ustreas.gov/press/releases/js1044.htm.

10. According to the Reisner study (Reisner, "Price Caps and the US Postal Service: Prospects, Perils and the Public Interest"), several legislative proposals in recent years have approached reform backwards by putting revised rate regulation (rate cap regulation) at the center of their plans while promising not to touch wages. Reisner argues that rate cap regulation can only succeed at a public institution like the Postal Service if costs are better controlled, the Postal Service's operations become more transparent, and Congress and regulators can create synthetic incentives that motivate those within the Postal Service to behave as though the government agency were a private-sector company. Reisner notes that most economists doubt that a government agency can somehow be given synthetic incentives mimicking those of a private-sector business, but he believes it can be done and cites several economists in support of his position. (For a cautionary tale, involving a Postal Service program, about how an incentive scheme can misfire, see Office Of Inspector General, U.S. Postal Service, "Use of the Economic Value Added Concept in the Pay for Performance Program," Report No. LH-AR-02-001, December 5, 2001, accessed at www.uspsoig.gov/foia_files/LH-AR-02-001.pdf; Office Of Inspector General, U.S. Postal Service, "Economic Value Added Variable Pay Program," Report No. LH-AR-02-001, July 31, 2000, accessed at www.uspsoig.gov/foia_files/ LB-AR-00-001.pdf; and Rick Merritt, "Stamping Out Productivity," *Washington Times*, January 9, 2002, p. A17.)

11. Ruth Y. Goldway, "Comments To The President's Commission On The United State Postal Service," Submitted by Ruth Y. Goldway, Commissioner Postal Rate Commission, February 3, 2003, accessed on the Internet at http://www.postcom.org/public/2003/goldway_statement.htm.

12. *Ibid*.

13. U.S. Postal Service, *United States Postal Service Transformation Plan*, April 2002, p. L-13, accessed on the Internet at http://www.usps.com/strategicdirection/transform.htm. The Postal Service optimistically provided an example showing how a drop in fuel costs could trigger a drop in postal rates. "For example, Priority Mail rates, set at "X", could decrease as fuel prices go below a specific level within a set time period." (*Ibid*.) The flip side, of course, is that a sharp rise in fuel costs could trigger a fuel surcharge if the Postal Service asked in a rate case for such an adjustment factor on some mail categories and the PRC agreed.

14. Testimony of John E. Potter, Postmaster General/CEO, U.S. Postal Service, before a Joint Hearing of the Committee on Government Reform, United States House of Representatives, and the Committee on Governmental Affairs, United States Senate, March 23, 2004, accessed on the Internet at http://reform.house.gov/UploadedFiles/USPS%20-%20Potter%20Joint%20Testimony.pdf.

15. See Postal Rate Commission, "Order No. 1358 - Notice of Proposed Rulemaking to Revise the Commission's Periodic Reporting Rule," Docket No. RM2003-3, January 8, 2003, accessed on the Internet at http://www.prc.gov/docs/36/36629/ORD1358.pdf.

16. See U.S. Postal Service, "Substantive Comments of the United States Postal Service," Response to PRC Order No. 1358, Docket No. RM2003-3, July 3, 2003, accessed on the Internet at http://www.prc.gov/docs/38/38562/Substantive.comments.final.rev.pdf.