

**Issue Brief**  
**April 21, 2003**

## **The Postal Service's Dangerous Game**

by Don Soifer, Executive Vice President

### EXECUTIVE SUMMARY

The U.S. Postal Service is playing a dangerous game: under-pricing product offerings in commercially competitive markets while over-pricing its monopoly service. This cross-subsidy harms:

- Captive regular mail users, forced to pay more than fair value for monopoly postal services;
- Commercial markets (overnight mail and package delivery, e.g.) that depend on true competition to match consumer need and supplier opportunity; and the Postal Service, itself, which focuses more on covering costs than controlling them, neglecting important statutory duties in the process.

Details follow.

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The U.S. Postal Service is playing a dangerous game. The harm falls mainly on ordinary postal patrons when they buy postage to send birthday cards, to pay bills, or to correspond with customers. The game involves the way the U.S. Postal Service prices its services in both monopoly and competitive markets.

### **The "game"**

During a January 8, 2003 public hearing of the President's Commission on the U.S. Postal Service, discussion turned to how the U.S. Postal Service might use pricing to "grow the business."<sup>1</sup> Oddly, there was no discussion of cutting rates, or increasing value, for regular first-class mail in order to stimulate volume increase. Instead, the focus was on aggressive pricing in markets where commercial competition exists. How aggressive? Postal Service Chief Financial Officer Richard Strasser tipped his hand with two closely related comments:

- "In the best of all worlds I'd like to say 'trust us and we'll set prices properly,' but we do have a letter-mail monopoly."
- "The marginal cost to deliver a parcel when we are delivering the rest of the mail is very small."<sup>2</sup>

What has the letter-mail monopoly to do with the Postal Service's "very small" marginal cost to deliver a parcel? The strategy Mr. Strasser alludes to should be understood as a cross-subsidy game, a discriminatory and predatory practice that is possible for those who have a monopoly in at least one market. It's an old trick: raising prices on captive monopoly customers to finance artificially low-ball prices in competitive markets in order to "buy" market share. To better understand how this works consider current Postal Service pricing practices.

Once total revenue requirements are established by compiling all USPS costs (including any prior year revenue shortfalls) the Postal Service allocates those costs among different service offerings such as first-class mail, parcels, third class ("standard") mail, etc. Costs generally fall into one of two categories: "institutional" or overhead costs and "attributable" costs, i.e., the direct and indirect costs incurred specifically for each product line. How much "institutional" or "overhead" costs are assigned to a specific service offering depends on how sensitive the volume of that particular service is to price changes.

Volume is quite sensitive to price changes in markets outside the Postal Service's core mission: regular letter mail. In those markets the Postal Service competes directly against firms that offer same-day bicycle delivery of local letters, firms that deliver large packages across the country, firms (including newspaper publishers) that distribute advertising flyers, and firms that deliver small packages and letters to most places in the U.S. overnight.

Because first-class mail volume is least price sensitive (it's illegal for anybody else to get in the business), the Postal Service loads all the overhead (the mark-up above attributed costs) it can get away with into the first-class mail rate base. If the first-class mail mark-up were comparable to mark-ups for express mail and packages, a first class stamp would be closer to 20 cents, compared to today's 37 cents. Of course, the high institutional costs of the Postal Service would not be met if stamps were only 20 cents. Without better cost-control, the fair allocation is probably somewhere in-between.

Meanwhile, who truly doubts that if the Postal Service were to stop accepting traffic other than first-class mail, it could trim its truck fleet, its sorting facilities, and its workforce by substantially more than the sum of the "attributed" costs for all those non-core postal products? In a nutshell, that is what first-class subsidization of the non-core product pricing is all about.

Instead, by using Mr. Strasser's rationale that "we are delivering the rest of the mail" anyway, the under-priced parcels and heavy-volume advertising pieces are riding on the backs of the already overburdened first class mail patrons. Michael Schuyler of the Institute for Research on the Economics of Taxation assesses this strategy quite clearly. His conclusion? "First-class mail users are being forced to subsidize other postal products."<sup>3</sup>

### **Why is this a dangerous game?**

First, it is dangerous for ordinary first-class mail users who are forced by the U.S. Postal Service to pay far more than the service they receive is truly worth. What is the fair value of the service? The Postal Service has argued, "Demand pricing, which considers the 'value of service' to the sender, should be given greater weight in . . . allocating overhead costs and setting postal rates."<sup>4</sup>

In others words, left to its own devices, the Postal Service would set prices as high as its monopoly-captive consumers are willing to pay before they finally say "Uncle!" and stop sending mail. Only a monopolist would call that "fair." Most others would peg a fair price no higher than a new competitor would charge to break even (including repaying investors) in an openly competitive market. The difference is as simple as winning a customer instead of bleeding him.

Monopoly-captive consumers are not the only ones at risk. The cross-subsidy game is also dangerous for both consumers and competitors in those otherwise competitive markets where the Postal Service plays outside its core mission. Natural competitors use rational economics to make business decisions, gauging their true, long-term cost of providing a competitive service. Besides the full cost of retail outlets, trucks, and employee compensation, they also include local, state, and federal taxes, and a profit margin. While profit targets vary, businesses generally do not enter markets unless their investors can expect after-tax returns better than low-risk investment alternatives such as Treasury bills or certificates of deposit.

By contrast, the Postal Service -- nonprofit and exempt from most taxes -- seems to be saying, "We can enter that market practically for free because the first-class mailers are already paying for our post offices, trucks, and personnel." No rational private sector business should be expected to compete against a subsidized competitor such as that for long.

Finally, the cross-subsidy game is dangerous to the Postal Service itself. The decision to buy market share (by setting prices below the true cost of the service) instead of earning it (by offering overall quality and value that betters the competition) essentially converts a service -- differentiated from its competitors' in a variety of ways -- into a commodity. Commodity offerings are differentiated on price alone. American enterprise history is littered with the bones of firms that tried to commoditize a service in order to buy market share only to collapse before killing off the competition in the price war. Service, of course, is sacrificed as long as price is the sole focus. This has happened in banking, commercial aviation, telecommunications, and other industries.

What makes the Postal Service different? The only factor that could enable it to continue to buy market share instead of earning it is its ability to recoup annual losses by subsequent rate increases for its monopoly customers. But this dubious safety net carries statutory limits.

Specifically, the Postal Service's mission includes the following mandates in federal law:

"The costs of establishing and maintaining the Postal Service shall not be apportioned to impair the overall value of such service to the people."<sup>5</sup>

"Postal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis."<sup>6</sup>

"In providing services and in establishing classifications, rates, and fees . . . the Postal Service shall not . . . make any undue or unreasonable discrimination among users of the mails."<sup>7</sup>

Postal Service rate practices should be scrutinized in that full statutory light, not merely on the deceptive basis of short-run marginal pricing.

Meanwhile, the Postal Service is not particularly needed in those markets that enjoy robust competition without it. Where *is* the Postal Service needed? To carry out its exclusive mission: universal service of nationwide letter delivery at a uniform price.

Or is it? When asked by the President's Commission whether the Postal Service has considered "privatization," Mr. Strasser responded that the Postal Service has contracted out some interstate transport of mail, but that once "you get to the local delivery level, economies of scale and scope take over."<sup>8</sup>

Economies of scale and scope are, of course, the conventional rationales for regulated monopolies.<sup>9</sup> However, actual outcomes have often caused monopoly consumers to yearn for, and win, competition in its place. Long distance telephony is but one example where competition blew the "economies of scale" rationale out the window for consumers, saving them on the order of 50% on calling costs.

With all due respect, it's not economies of scale or scope that keep new market entrants outside the threshold of the non-urgent letter market. It's the threat of criminal prosecution if they dare to enter.<sup>10</sup> Yet when the Postal Service ventures outside *its* monopoly reservation to play in *other* markets using discriminatory pricing practices financed by monopoly captive customers, it faces -- as yet -- no restraint to speak of.

U.S. Postal Service effort does not seem focused on serving "on a fair and equitable basis" the people it is constituted to serve, namely senders of regular letter mail. Instead, the Postal Service seems preoccupied with expansive growth for its own sake. This is the dangerous game it continues playing at the cost of its captive consumers, and at its own peril.

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<sup>1</sup> Testimony before the President's Commission on the U.S. Postal Service, January 8, 2003.

<sup>2</sup> *Ibid.*

<sup>3</sup> Institute for Research on the Economics of Taxation Congressional Advisory # 141 "Does First -class Mail Carry Too Much Overhead?" p. 2.

<sup>4</sup> *Ibid.*, p. 5 *citing* "Comments From the U.S. Postal Service," in Appendix IV of GAO, "Pricing Postal Services in a Competitive Environment" GAO/GGD 92 -49 (March 1992).

<sup>5</sup> 39 U.S.C. Sec. 101(a).

<sup>6</sup> 39 U.S.C. Sec. 101 (d).

<sup>7</sup> 39 U.S.C. Sec. 403(c).

<sup>8</sup> *See* note 1.

<sup>9</sup> W.K. Jones, *Cases and Materials on Regulated Industries* (2<sup>nd</sup> Ed). Foundation Press, 1976; pp. 4 -5.

<sup>10</sup> 18 U.S.C. Sec. 1725.

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