# Going Postal

## *Regulatory Reform for the Digital Age*

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[The post office] is perhaps the only mercantile project which has been successfully managed by, I believe, every sort of government.
—Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*

Any mention of regulatory reform brings to mind previous legislative efforts that improved performance in the airline, trucking, and telecommunications industries. The recently enacted postal-reform legislation is a disappointment, however, not only by these standards, but also by almost any other.

The U.S. General Accounting Office, the American Enterprise Institute, the Cato Institute, and a handful of market-oriented independent scholars have published many copious volumes over the years detailing the need for extensive reform of the U.S. Postal Service. The need arises from two concerns. The first flows from conventional economic theory, which argues that a government-operated virtual monopoly that is partly de jure, partly de facto, and almost certainly not "natural" underserves the country owing to its high costs, bland offerings, and comparatively middling service. The argument draws comparisons with private delivery firms such as United Parcel Service (UPS) and Federal Express (FedEx), which have taken away the lion's share of the package-delivery business from the Postal Service. These firms operate profitable delivery networks over the same streets traversed by the Postal Service,

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indicating the lack of natural-monopoly conditions in local delivery. The Postal Service's own outsourcing of long-haul transportation, sorting, and barcoding functions signals the absence of significant scale and scope economies for the balance of its core functions. No compelling economic reason therefore exists for using statutes and criminal penalties to shield one-half of the Postal Service's mail volume against competition from private carriers. Neither does a valid rationale exist today for providing postal services through a government entity, national-security needs aside. The European Union and several other countries already have begun demonopolizing and privatizing their postal operations, subject only to prescribed minimum delivery standards and universal-service obligations. Countries that managed postal services successfully in Adam Smith's day now admit that they cannot manage them efficiently, a point of importance in this age of technological competition.

The second concern about postal operations is more ominous. The Postal Service's de jure monopoly of the letter-delivery business, which pays the bulk of its institutional overhead costs, is being eroded by electronic communications that are faster, more convenient, more reliable, and less expensive than traditional mail. First Class Mail volumes have been declining for several years and at a faster pace than was predicted only a few years ago. This decline harbingers a future of falling postal revenue and rising average cost. More than 60 percent of the Postal Service's forty thousand post offices are unprofitable, and this number will increase as the volume of letter mail declines. Sustaining the Postal Service in its present form may entail potentially large federal subsidies, broadened de jure monopoly protections, and perhaps the extension of postal regulation to encompass electronic alternatives to letter mail.

A prudent course of action at this juncture is to reform the Postal Service in a way that squares its traditional operations with twenty-first-century realities. The U.S. Postal Service was created in 1971 from the ruins of the former Post Office Department, which was a Cabinet-level, patronage-riddled bureaucracy whose annual deficits reached 25 percent of operating costs. The Service's job was to put postal operations on a businesslike footing. Its creation unfortunately coincided with bold pronouncements by serious economists, weekly news magazines, and many public intellectuals to the effect that capitalism could not survive the realities of a modern industrial economy. The 1968 presidential commission that recommended reform of the Post Office Department rejected privatization as the means to this end. The upshot, as noted by law and economics scholar George Priest, is that the Postal Service "remains today as the most significant example of socialism in the United States . . . [embracing] almost all the aspects of socialism rejected in Eastern Europe and in the privatized Western economies" (1994, 50).

Comprehensive postal reform will be difficult to effect until the Postal Service teeters on the brink of collapse. It is not there yet. The price of a First Class stamp increased to forty-one cents in 2007, which is still at the low end of its post-1971 inflation-adjusted price range. Moreover, the mailing public awards the Postal Service resoundingly favorable performance ratings. There is thus no taste for comprehensive postal reform at present, and public resistance against it might be easy to mobilize.

Vested interest poses a second obstacle to reform. The Postal Service, unlike the airline, trucking, and telecommunications industries, is an entrenched federal bureaucracy. It employs eight hundred thousand voting and highly unionized workers, totaling nearly one-third of the federal civilian workforce. Wages represent 80 percent of its operating costs. Studies of the wages and benefits it pays indicate a 30 percent compensation premium compared to the private sector, totaling $9 billion, or 15 percent of the Postal Service's annual revenue requirement. The sentiment in Congress understandably echoes that of the vigilant and aggressively protective postal unions: "Our Postal Service isn't broken. The last thing we need is for Congress to try to 'fix' it" (qtd. in Taub 2000, 189).

## The Postal Reform of 2006

"Fix it" is what Congress did not do in 2006, despite the General Accounting Office's dire warning that "comprehensive postal reform is urgently needed . . . to minimize the risk of a significant taxpayer bailout or dramatic postal rate increases" (Walker 2004, i). Congress instead passed a timid reform bill that scarcely addresses the Postal Service's impending problems. We might more optimistically imagine that Congress was laying a foundation for further and more substantive reform.

Congress became interested in postal reform a decade ago. The upshot of this effort was the Postal Accountability and Enforcement Act of 2006 (HR 6407 and Public Law 109-435). This act amends Title 39 of the U.S. Code and revises the Postal Reorganization and Salary Adjustment Act of 1970 (Public Law 91-375), which created the U.S. Postal Service and the Postal Rate Commission.

The 2006 act concentrates largely on administrative reforms. It allows the Postal Service to adjust rates (prices) without regulatory scrutiny so long as increases do not exceed changes in the Consumer Price Index (CPI). The intent is to check rate increases while permitting the service to respond more quickly to changing cost and market conditions. The renamed Postal Regulatory (née "Rate") Commission is relieved of ratemaking oversight responsibility so long as increases do not exceed the CPI caps. The act otherwise refocuses the commission's efforts onto fashioning rules and regulations for governing postal operations, conducting statutorily prescribed analyses and reviews, and acting in concert with the Postal Service to improve service quality, streamline operations, and increase operating efficiency. The commission will oversee the Postal Service's efforts to "rationalize the postal facilities network" (Sec. 302) by consolidating and closing unprofitable post offices, an economy measure that the 1970 Postal Reorganization Act expressly prohibited. The 2006 act also prescribes a range of administrative changes, such as revising the regulations governing the Postal Service's reserves for pension and health-care liabilities. These changes, though significant, lie apart from regulatory reform issues and so are not considered here.

## *Pricing Reform*

The overarching mission of postal ratemaking—"binding together a nation"—is literally carved in stone at the District of Columbia's Main Post Office building (Adie 1989, 46). The old Post Office Department had little systematic knowledge of its costs and knew even less about postal demand characteristics. It set prices largely on the basis of mission statement, guesswork, and politics. Financial losses were covered by general tax revenues.

Section 3622(b) of the 1970 Postal Reorganization Act prescribed nine quasi-economic criteria for fashioning rates:

> (1) the establishment and maintenance of a fair and equitable [rate] schedule; (2) the value of each class or type of mail service to both the sender and recipient, including but not limited to the collection, mode of transportation, and priority of delivery; (3) the requirement that each class of mail or type of mail service bear the direct and indirect postal cost attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type; (4) the effect of rate increases on the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters; (5) the availability of alternative means of sending and receiving letters and other mail matter at reasonable costs; (6) the degree of preparation of mail for delivery into the postal system performed by the mailer and its effects on reducing costs to the Postal Service; (7) simplicity of structure for the entire [rate] schedule and simple, identifiable relationships between rates or fees charged the various classes of mail for postal services; (8) the educational, cultural, scientific, and informational value to the recipient of mail matter; and (9) such other factors as the Commission deems appropriate.

Section 403(c) of the 1970 act further required that rates not "make any undue or unreasonable discrimination among users of the mails, nor . . . any or unreasonable preferences to any such user." These criteria can support any reasonable rate structure and levels, and they have served to perpetuate the structure that existed in 1970.

The 2006 act replaced this ratemaking scheme with a price-cap system that ties rate increases to changes in the CPI. The idea of using the CPI to control rate increases and stimulate productivity growth originated more than two decades ago in England, where it has been used for pricing the gamut of public-utility services. CPI price caps have been used in the United States for nearly as long, mostly for pricing telecommunications services. Their usefulness lies in the capacity to constrain earnings and promote operating efficiency by imposing binding constraints on prices. Their efficiency is typically enhanced by subtracting an "X" factor from the change in the CPI to compel cost reductions and spur productivity increases, and by permitting private firms to retain a portion of any profits earned under the caps.

Applying price caps to the Postal Service will produce none of these desirable effects, notwithstanding hopes and assertions to the contrary. As a government entity, the Postal Service has no residual claimants (shareholders) who stand to profit under a price-cap regime. Consequently, there is no significant incentive for management to alter the existing pattern of postal X-inefficiencies. Moreover, the 2006 act permits the Service to exceed the CPI cap whenever its financial circumstances warrant, subject only to regulatory review. The threat of review might provide an incentive for the service to hide beneath the caps by chiseling on service quality. The caps otherwise impose no constraint on postal rates that does not exist already. The act omits the customary "X" reduction factor, presumably because any such adjustment would be superfluous.

The 2006 act grants the Postal Service one year in which to file a final omnibus rate application, using the old ratemaking rules, to position rates for price caps. It is expected to do so in the later portion of 2007, with the new rates and caps taking effect in 2008. The Postal Regulatory Commission is obliged to review the effectiveness of price-cap regulation after ten years.

## *Service Classification*

The 2006 act separates postal services into two categories for ratemaking and oversight purposes: market dominant and competitive. The initial assignment of services to these categories follows existing rate classifications and reflects the highly price-inelastic demand for most postal services. The Postal Regulatory Commission is obliged to review these assignments continuously and to adjust them as circumstances warrant.

The market-dominant service category comprises all letter, periodical, and advertising mail. Rates for these services are subject to price caps. The competitive category, by contrast, comprises mostly parcel-delivery services, for which own-price demand elasticities are relatively high and the Postal Service's market share is small. The Postal Service is free to adjust rates for competitive services, provided that new rates exceed all relevant economic costs and make an "appropriate" contribution to paying the Service's overhead expenses. What is "appropriate" for a given service may be the nub for future antitrust litigation, which is enabled by the act's withdrawal of the Postal Service's statutory immunity from lawsuits involving competitive offerings. The act prohibits the service from entering markets and offering services that are not related directly to its core postal business.

The 2006 act lets stand the Private Express Statutes (39 C.F.R. 310), which prescribe a de jure monopoly for the carriage of letter mail. These statutes, which date to the mid-1800s, assess criminal penalties against pirate carriers and rogue mailers. The act also lets stand the Postal Service's exclusive use of mail boxes, a de jure monopoly that dates to 1934. The act obliges the commission to examine the continued relevance of both monopolies and to report its findings within two years.

The Private Express Statutes encompass all communications that substitute closely for letter mail. The Postal Service, acting on its own initiative and contrary to its board of governors' recommendation, promulgated lawful regulations in 1974 that significantly expanded the statutes' original scope (Donnici et al. 1977). The justification for this extension turned on the assertion of scale economies and natural monopoly and on the need for administrative convenience. These extensions remain in effect and arguably encompass all of the instant-message, e-mail, electronic billing, and electronic bill-payment services that now compete directly with First Class letter mail. Neither the Postal Service nor the Postal Rate Commission ever sought to assess statutory penalties against electronic mailers, undoubtedly fearing the economic dislocation and political backlash that would result. The newly constituted Postal Regulatory Commission is unlikely to recommend either that the statutes be read prospectively in this manner or that its own authority be extended to encompass electronic-message services. Congress would be unlikely to consider either recommendation seriously. However, it might entertain the idea of funding a subsidy for basic postal services through a small tax on electronic messages assessed in lieu of the onerous statutory penalty.

The Postal Service briefly offered two electronic services in the early 1980s, E-COM and INTELPOST, which allowed mailers to transmit letters electronically throughout the United States and the world. Contents were printed at destination post offices and delivered locally by regular post. Both services were costly failures. Subsequent proposals by the Postal Service to assign an e-mail address to every physical delivery address in the United States and to manage the *.us* Internet domain generated no outside enthusiasm and were quickly abandoned.

## *Regulation*

The Postal Rate Commission, created by the 1970 Postal Reorganization Act, was unlike any other federal regulatory agency. It had no substantive regulatory authority over rates, revenue requirements, postal operations, or lawfully competing carriers. Its scope was limited to reviewing the Postal Service's rate and mail-classification proposals, conducting public hearings, transmitting findings and recommendations to the Postal Service's board of governors, and reporting periodically to Congress. The 1970 act divided ratemaking authority among the Postal Rate Commission, the Postal Service, and the Service's eleven-member board of governors, which directs policy and oversees operations. Ratemaking was a joint and largely transparent activity under this arrangement.

The Postal Service successfully challenged the commission's attempts to regulate beyond the scope of its authority. By the U.S. Court of Appeal's lights, "Congress did not intend that the Postal Rate Commission regulate the Postal Service; one partner does not regulate another, and authority to assist in ratemaking and classification does not include authority to interfere in management. . . . The responsibilities of the Postal Rate Commission are strictly confined to relatively passive review of rate, classification, and major service changes" (*Governors of the U.S. Postal Service v. Postal Rate Commission,* 654 F.2d 108, 117 [D.C. Cir. 1981]). In a related case, the court stressed that "the Board [of Governors], and not the [Postal Rate Commission], is responsible for making policy decisions for the Postal Service. Should the Board exceed its authority or make questionable policy choices, remedies may be pursued through congressional amendments or judicial review. Further, the President may influence the Board's policy decisions through his appointment powers. Aside from these checks, the Board is free to fashion policies of the Postal Service without interference, including from the PRC" (*Newsweek, Inc. v. United States Postal Service,* 663 F.2d 1186, 1205–06 [2d Cir. 1981]). Congress plainly intended that the Postal Service would operate as a sovereign central planner and that the Postal Rate Commission would act as its public eyes, ears, and conscience.

The 2006 act changes the latter agency from a "rate" commission to a "regulatory" commission and enlarges its authority. The commission's scope nevertheless remains below the level customarily associated with the economic regulation of industry. The full contours of its authority are unknowable from the act's black letter. It is fair to conclude, however, that its relationship with the Postal Service will be more adversarial than in the past. One reason for thinking so is that the commission now is authorized to subpoena testimony and documentary evidence. It surely will test the limits of its new authority, as is customary for regulatory agencies, and the Postal Service will resist. The Court of Appeals will settle turf battles, as previously, by ascribing meaning to the act's provisions.

Any future legislation demonopolizing and privatizing the Postal Service undoubtedly will enlarge the commission's regulatory scope as well. The lesson from telecommunications teaches that regulation of workably competitive markets consumes vastly greater resources than does the regulation of virtual monopolies, in part because competitive markets hold greater opportunities for regulatory mischief.

## Wage Premiums

Studies of wages and benefits paid by the Postal Service show compensation exceeding comparable private-sector levels by 30 percent (Wachter, Hirsch, and Gillula 1995). As noted earlier, the premium amounts to $9 billion, or approximately 15 percent of the service's annual revenue requirement. The postal unions dispute the 30 percent figure (Medoff 2003), although it is widely accepted as valid. The premium is the consequence of congressionally mandated labor rules, cumulative binding arbitration awards, and adverse management incentives that obviate hard bargaining over labor issues (Froelke 2000). The 2006 act makes no effort to control these costs. Congress understandably is reluctant to incur the wrath of eight hundred thousand highly organized government employees who not only vote, but also can express displeasure by slowing or halting the mail. Price caps will have no meaningful effect on wage and benefit costs, although the act's passage was delayed by postal union concerns that they might do so.

Empirical work indicating a management-compensation premium is elusive, but there are good reasons for suspecting that a premium exists. The Postal Service offers an attractive compensation package that includes bonuses and promotions, provides secure employment, maintains a comparatively high management-to-labor ratio, and imposes no meaningful profit-and-loss responsibility on management. Statutory limits on federal employee compensation prohibit the Postal Service from rewarding its most senior executives at private-sector levels.

The Postal Rate Commission's characterization of the documented wage premium is remarkably accommodating. Its testimony before the 2003 President's Commission on the Postal Service examined whether "economies of scale in the delivery functions exceed the technical inefficiencies and economic rents of the postal monopoly." It concluded that "$6 billion represents the benefits from scale economies in delivery. But labor costs also must be taken into account . . . the monopoly rents [wage premium], $9 billion, exceeds the benefits of scale in the delivery system, $6 billion, by $3 billion." The commission had not studied the full extent of Postal Service X-inefficiency, but it stated that "to the degree the Postal Service is technically inefficient those costs should be added to the $9 billion in rents in order to compare the costs and benefits of the delivery monopoly" (Cohen 2003, 36, 37). These statements imply that regulators and legislators must accept the rough with the smooth where postal operations are concerned. The inference is misleading, though, because the measures are not commensurable. The 30 percent wage premium paid by the U.S. Postal Service exceeds the corresponding 6 percent premium paid by the British Post Office (Crew 1996, 93), and it would be reduced to zero by a for-profit monopolist. Furthermore, a private, competitive postal industry might generate comparable if not larger scale and scope economies. The sum of these diverse measures reveals nothing useful about the intrinsic economic costs and benefits of the existing industry's structure.

## Postal Regulation and Public Choice

One argument in support of postal demonopolization and privatization turns on the suspected ability of private factions to influence ratemaking and classification decisions unduly. The Postal Service's $60 billion annual revenue requirement, coupled with its de jure monopoly over letter mail, places potentially large rents within the reach of factions that can compete effectively for them. Business mailers' interests unsurprisingly are well represented, both in rate proceedings and behind the scenes, where mailers not only badger the Postal Service at all levels for favorable treatment, but also participate in congressional oversight hearings on postal operations and raise issues ex parte with members of Congress and the executive branch of government.

Public-choice theory supplies two testable predictions along these lines. The first is that the Postal Service's management and unions capture rents both by exploiting the de jure letter monopoly and by bargaining for a share of the cost savings that arise from productivity gains, outsourcing, and work sharing. The Service's $9 billion wage premium and compassionate work rules are consistent with this prediction. The second prediction is that private-sector factions manipulate the ratemaking process. Rent-seeking efforts by high-volume mailers are presumed to lower rates for periodicals and advertising mail, and efforts by competitors such as UPS and FedEx are thought to raise the service's rates for parcel services. The burdens of successful rent seeking are borne perforce by First Class mailers.

The Postal Service's rate schedules traditionally have reflected a pattern of disparate markups above marginal cost. (Marginal cost also is called "attributable" and "volume variable" in postal jargon.) The Court of Appeals concluded that "[d]iscrimination in postal ratemaking in favor of certain preferred classes of mail and to the great disadvantage of first class mail has long been a part of our postal system" (*National Association of Greeting Card Publishers v. U.S. Postal Service,* 569 F.2d 570, 587 [D.C. Cir. 1976]). Economists interpret this pattern of discrimination as consistent with factional influence (see, for example, Geddes 1994, 135–36). However, the observed pattern also is consistent with the pattern of economically efficient rates dictated by price theory's "inverse elasticity" rule. The rule requires that markups over marginal cost vary inversely with the own-price elasticity of demand. It implies that services with relatively low own-price elasticity, such as First Class Mail, must bear, for efficiency's sake, a disproportionately large share of the Postal Service's institutional cost burden. This implication raises intense political concerns about normative rate fairness, notwithstanding that efficient rates benefit all mailers in the aggregate. (Technically, efficient rates that exceed marginal cost are only second-best efficient. First-best efficiency occurs when rates equal marginal cost, but marginal-cost pricing is untenable for postal services because it would produce insufficient revenue to cover institutional costs.)

The predictions of public-choice theory can be checked by comparing the established markup for each mail subclass against its efficient inverse-elasticity benchmark. (In the argot of postal ratemaking, "markup" is the amount by which price exceeds marginal cost, expressed as a percentage of marginal cost.) Rates that fall either above or below the benchmark impose an efficiency cost on the Postal Service, which makes the benchmark a uniquely rational reference point. A prediction is confirmed if the established markup for a subclass of periodical or advertising mail falls below the respective benchmark or if the markup for First Class, Parcel Post, Priority, or Express Mail exceeds it.

Benchmarks can be calculated using an iterative technique known as Ramsey pricing. The technique is an applied form of the inverse-elasticity rule that also incorporates the cross-price elasticities between substitutable and complementary services. The calculations produce a set of markups that exactly and efficiently satisfy the Postal Service's revenue requirement. The Service filed a Ramsey study with its 1997 omnibus rate application (Bernstein 1997, see especially tables 4, 11, and 17, on pp. 35, 55, and 88, respectively). The study's results are distorted by heuristic adjustments and other technical factors, but they are useful nevertheless for evaluating the public-choice predictions for periodical, advertising, parcel, and First Class mail, which together constitute 90 percent of the Postal Service's annual revenue.

*Periodicals (Standard-A Mail, formerly called Second Class Mail)*. The public-choice prediction for this class of mail is that the established markup is less than the corresponding Ramsey benchmark. The prediction is confirmed.

The own-price elasticity of Regular periodical mail is –0.143. This value is exceptionally low, and the Ramsey benchmark is correspondingly very high. The Postal Service's study arbitrarily constrains the benchmark at 114 percent, which is below the true Ramsey mark (Bernstein 1997, 61–62). By comparison, the established markup is 22 percent, yielding at least a $1.3 billion benefit to mailers (Bernstein 1997, 55).

*Advertising (Standard-A Mail, formerly called Third Class Mail)*. The prediction once again is that established markups are below the benchmarks. The results for this mail class are mixed.

Standard-A comprises two subclasses: Regular and Enhanced Carrier Route (ECR). The two were lumped together as Bulk Regular Mail prior to being split into separate subclasses after 1995. The services are used by different kinds of mailers and require different levels of work-sharing preparation. ECR mail blankets addresses within a geographic areas, whereas Regular Mail targets recipients selectively. The ratemaking interests of both mailer groups are well represented.

The own-price elasticity of Regular Mail is –0.382, and the Ramsey benchmark is 78 percent. The established markup for this subclass is 32 percent, which translates to a $0.7 billion benefit to mailers (Bernstein 1997, 55). The public-choice prediction is confirmed.

The own-price elasticity for ECR mail is –0.598, and the Ramsey benchmark is 20 percent. The established markup for this subclass is 144 percent, producing a $1.7 burden on mailers (Bernstein 1997, 55). The prediction is rejected.

*Parcel Mail*. The Postal Service offers three parcel-delivery services: Parcel Post (Standard-B Mail, formerly Fourth Class Mail) provides regular parcel service; Priority Mail provides an expedited service that is equivalent to First Class Mail; and Express Mail provides overnight delivery. These services compete with private carrier offerings (the Private Express Statutes do not apply to parcel delivery), and the Postal Service's market share in each segment is small. Individuals and small-business mailers depend on the Postal Service, whereas high-volume mailers typically use competing services. Parcel services have the greatest own-price elasticities among the rate classes. They are described as "competitive" under the 2006 act, which ostensibly authorizes the Postal Service to price them at profit-maximizing levels.

Public-choice theory predicts that the established markups for these services exceed their respective benchmarks. The prediction is confirmed for Priority Mail, but rejected for Parcel Post and Express Mail.

Priority Mail is by far the largest of the three parcel services. Its own-price elasticity is –0.770, and the Ramsey benchmark is 26 percent. The established markup for this subclass is 130 percent, producing a $0.9 billion burden on mailers (Bernstein 1997, 55). The prediction is confirmed.

The own-price elasticity for Parcel Post is –0.965, and the Ramsey benchmark is 25 percent. (The cross-price elasticity between Parcel Post and Priority Mail produces only a slightly lower benchmark for Parcel Post despite its significantly higher own-price elasticity.) The established markup for Parcel Post is 10 percent, which is substantially below the benchmark and yields a $0.1 billion benefit to mailers (Bernstein 1997, 55). The prediction is rejected.

The own-price elasticity for Express Mail is –1.534. Because this elasticity is exceptionally high relative to other subclasses, the Ramsey benchmark is close to zero and so prices Express Mail nearly at marginal cost. The Postal Service's study constrains the benchmark at 72 percent, which is the minimum markup needed to cover both marginal and incremental costs (such as for advertising). This minimum provides no contribution to institutional cost coverage; stated differently, the normatively "appropriate" contribution level is zero. Express Mail's high own-price elasticity ($\xi$) indicates, however, that competitive pressure imposes a binding pricing constraint under the assumption of profit maximization. The indicated profit-maximizing benchmark is 187 percent, as calculated using the inverse-elasticity formula $(1/[|\xi| - 1]) \times 100$. By comparison, the established markup is 113 percent, indicating a $0.6 billion benefit to mailers compared to the profit-maximizing benchmark (estimated from Bernstein 1997, 55). The public-choice prediction is rejected.

*First Class.* This mail class is the monopoly cash cow that bears the consequences of pricing inefficiencies elsewhere. The prediction is that the established markup exceeds the Ramsey benchmark. The aggregate own-price elasticity for First Class letters is –0.232, and the established markup is 100 percent. The benchmark shown in the Postal Service's Ramsey study is 103 percent, but this value is derived heuristically, so is not useful for checking predictions. Fortunately, an alternative comparison can be developed by using disaggregated elasticities for the two constituent categories of First Class letters: single piece (low-volume mail) and work shared (high-volume mail that is sorted and barcoded by mailers).

Single-piece letters are mailed by individuals and small businesses. This mail historically constituted more than 50 percent of First Class letters, but the percentage is somewhat lower today. The ratemaking interests of single-piece mailers were represented in the ratemaking process by the Postal Rate Commission's internal Office of the Consumer Advocate and occasionally by greeting-card manufacturers. The interests of high-volume, work-sharing mailers are well represented privately. The public-choice prediction, on balance, is that the markup for single-piece mail exceeds that for work-shared mail. This prediction is rejected.

The own-price elasticity is –0.189 for single-piece letters and –0.289 for work-shared letters (Bernstein 1997, 35). The inverse-elasticity rule dictates that the single-piece benchmark must be the higher one. However, the established single-piece markup is 69 percent, and the work-shared markup is 172 percent (both percentages are calculated from Bernstein 1997, 87). This pattern contradicts both the inverse-elasticity rule and the public-choice prediction.

*Summary.* This cursory examination of pricing patterns confirms some public-choice predictions and rejects others. The results beg for an explanation. There are two.

The first explanation is that many of today's persistent rate anomalies are rooted in rate structures implemented by the former Post Office Department. The structures have been perpetuated by a combination of the Ptolemaic Section 3622(b) ratemaking guidelines and a marked preference for rate stability that characterizes the "if it ain't broke" school of ratemaking. Recent efforts by mailer factions to influence rates may have prevented favorable markups from regressing to efficient levels, but probably have not widened the gaps appreciably, if at all. The markups for work-shared First Class letters and ECR advertising mail support this conclusion. Large-scale work sharing arose after 1970 and saves the Postal Service billions of dollars in annual cost. The service returns a nominal portion of this savings to mailers through compensatory rate discounts designed to induce efficient work-sharing efforts. Mailers have enjoyed little recent rent-seeking success from manipulating these discounts. However, their efforts in this regard have precipitated some quasi-efficient ratemaking changes that benefit mailers to some extent and postal operations to a greater extent.

The second explanation for the failure of many public-choice predictions is the joint and transparent ratemaking arrangement involving the Postal Rate Commission, the Postal Service, and the Service's board of governors. Ambition counteracts ambition across the board and makes rent seeking nearly impossible at this level. Two potentially more fruitful sources of rent-seeking pressure are Congress and the executive branch of government, which can broker ratemaking deals through back channels, fund preferential discounts out of general tax revenues, and mandate discounts that must be funded through rates for other services. Evidence of successful rent seeking is meager here as well. Congress stopped the funding for discounts to most nonprofit mailers in 1993, shifting the burden onto other rate payers. It also has ignored proposals to mandate novel discounts for news periodicals that meet arbitrary standards for journalistic excellence. Only one recent executive-branch action has been observed. Immediately prior to leaving office in January 1993, President George H. W. Bush threatened to replace the Postal Service's board of governors if its members did not withdraw a legal challenge to a two-cent work-sharing discount for First Class prebarcoded letters, which had been recommended by the Postal Rate

Commission (Geddes 1994, 132–33). The president's subsequent attempt to replace board members was thwarted by the Federal District Court, which ruled that the action violated the board's statutory independence. The discount eventually became effective despite the furor.

## Rate Adjustment under Price Caps

The 2006 act grants the Postal Service one year in which to file a final omnibus rate application to prepare its rate schedules for price caps. The Service is expected to use this opportunity to nudge existing markups closer to efficient levels. Doing so would help it to offset growing financial pressures. Increased pricing flexibility under price caps will help it maintain efficient rates over time, provided that its financial condition does not deteriorate precipitously.

The extent to which the Postal Service uses Ramsey studies informally for evaluating rate proposals is unknown outside of the service itself. The Postal Rate Commission, which experimented with inverse-elasticity techniques during the 1970s, has rejected Ramsey pricing as a formal ratemaking tool. It reasons that the Postal Service's marginal costs are not optimal (among other things they are inflated by a large wage premium) and that marginal costs (and their measurement) are subject to covert manipulations in support of tendentious rate proposals (Postal Rate Commission 1998, 1:239–45). The commission thus sidestepped the issue of replacing its own collective judgment with the slide rule.

Other critics of Ramsey pricing have voiced similar concerns. Two economists from the American Enterprise Institute argue:

> The postal ratemaking process has unusual cost allocation and accounting procedures that bear little relationship to economic theory. Conventional regulatory safeguards to prevent cost misallocation are absent from postal rate regulation. The statutory monopoly over letter mail conferred on the Postal Service by the Private Express Statutes intentionally suppresses competition and consumer choice. The Postal Service's understanding of Ramsey pricing principles is faulty.
>
> When these factors are combined in the postal ratemaking process, it becomes clear that reliance on inverse elasticity pricing could maximize consumer welfare only by sheer accident. It is far more likely that postal rates set in such a manner would harm consumer welfare and competitive markets for postal services. It would be a mistake to employ inverse elasticity pricing until postal regulation has been dramatically reformed, or until the Postal Service has been commercialized and the Private Express Statutes have been repealed. (Sidak and Spulber 1996, 140)

These authors' overarching concern is that Ramsey-optimal prices for competitive postal services fall below equilibrium market prices. Their point is a valid one. Recall the foregoing analysis of competitive Express Mail, for which the Postal Service's Ramsey study indicates that prices be set essentially at marginal cost. The Service's study constrained the markup at 72 percent, allowing no contribution to overhead cost coverage. However, the 187 percent profit-maximizing markup indicated by the inverse-elasticity rule, which almost certainly is overstated because it does not correct price elasticity to reflect the large price increase, might price the Postal Service out of the overnight-delivery business. Pricing for competitive services thus requires close scrutiny, and the 2006 act obliges the commission to provide it.

The Postal Service has means other than price, letter and mailbox monopolies, and control over bottleneck facilities for quelling competition. It can also do so by reclassifying services. In Docket R97-1, Postal Service volume-forecasting witness George Tolley commented on the effects of a 1995 mail reclassification by describing how one high-volume magazine mailer "found it attractive to transfer [to the Postal Service] the distribution of . . . larger volume magazines that had been delivered via alternative delivery" (1997, 105). Competitive distributors of advertising material similarly discovered "that they cannot compete head-to-head with the Postal Service in all aspects of mail delivery." The Postal Regulatory Commission presumably will scrutinize all such competitive tactics and effects.

Whether the commission's enforcement powers are sufficient to protect competition against inappropriate pricing tactics remains to be tested. A greater concern might be that the commission will feel obliged to shield the Postal Service against stiff competition. Economist William Baumol, who draws on many decades of participation in the regulatory process, says that the regulators he observed

> consistently sought to avoid difficulties for themselves by attempting to preserve a viable existence for all firms that fell under their jurisdiction, whether those firms were run competently or incompetently, whether or not those enterprises were positioned by location or other characteristics to serve the market efficiently, and whether or not those companies had a record of sustained innovation. At the same time, these regulatory agencies, in my view, undertook to ensure that no firm under their jurisdiction could enjoy such a degree of success that it would attract unfavorable public or political attention, doing so in particular by placing ceilings on profits that denied any regulated firm the possibility of unusually high earnings, even through the achievement of a record of extraordinary productivity growth and product or process. (1993, 82–83)

The commission is unlikely to face the embarrassment of high Postal Service earnings. The 2006 act prevents the service from entering noncore lines of business, and wage pressure from the postal unions, coupled with price caps, are likely to prevent it from exceeding its break-even revenue requirement. By contrast, the effects of increasing competition might tip the commission into "protective" mode. Defending competition against the combined defensive actions of the Postal Service and the commission poses a potentially serious challenge, a generic lesson learned decades ago by the telecommunications industry.

## Conclusion

The Postal Accountability and Enhancement Act of 2006 does little to reform the postal industry. It privatizes no part of the U.S. Postal Service, although outsourcing and work sharing, which are tantamount to partial privatization, continue apace. It maintains de jure postal monopolies and makes no adjustment to congressionally mandated labor requirements. In short, the act deals directly with none of the issues and concerns that have prompted the European Union and other countries around the globe to abandon their state-run postal operations (Campbell 2000).

On the brighter side, the act directs the Postal Regulatory Commission to undertake studies that are relevant to future legislative reform. This work is to be completed within two years, at which time it will be evaluated by a Democrat-controlled Congress whose reform sensibilities may differ from those of the Republican Congress that passed the 2006 act. In any event, steps toward comprehensive postal reform are best taken at the first opportunity because competition from cyberspace is draining the cash cow, and factions internal to Congress and the Postal Service have demonstrated their ability to delay reform legislation.

The lesson from telecommunications teaches that modern regulatory reform can be a perilous endeavor. A recent book written by a pair of telecommunications scholars (Nuechterlein and Weiser 2005) highlights the sort of problems that postal reform might encounter. It notes that telecommunications reform "triggered some of the fiercest public policy wars ever waged" (2). The Telecommunications Act of 1996 "was effectively written by warring interest groups that believed they were playing a zero-sum game" (413). The result was "a crazy-quilt of ambiguous provisions designed . . . to leave many of the important questions unanswered so as to offend no powerful interest groups" (28). The authors cite instances of how "opposing political factions [kept] the FCC [Federal Communications Commission] in a state of near-paralysis for several years" (164) and conclude that this commission "often seems more adroit at jury-rigging intellectually sloppy deals to appease industry factions in the short term than at making the analytically sound but politically difficult policy choices needed to promote long term economic efficiency" (426). They also quote approvingly the economist and regulatory authority Alfred Kahn, who condemned one FCC policy report as "an abomination, purely political in the worst sense of the term and grounded in neither good economics nor honorable regulatory practice" (qtd. at 108). (Kahn [1998] offers many other harsh criticisms of the reform process.) The authors might also have quoted the former FCC commissioner Harold Furchgott-Roth, who denounced fellow regulators for engaging in "shakedowns, extortions, and things that fall outside the formal regulatory process" (qtd. in McCullagh 1999).

The past is not necessarily prologue. Nevertheless, skepticism and vigilance are indicated lest postal services, like telecommunications, emerge from legislative reform as an unnecessarily lawyer-driven industry.

The 2006 Postal Accountability and Enforcement Act will have no dramatic near-term effect apart from closing some unprofitable post offices. More substantive postal reform appears to be unavoidable in the longer term, however, and it is warranted in any event. Either way, the 2006 act appears destined to become a temporary measure.

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