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Rebuttal Comments Submitted to

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I am submitting the following as rebuttal comments regarding the testimony that was presented

at the Commission's February 20 Hearing. My comments concern the testimony of Professor David Sappington and James Campbell. The views here are my own and do not necessarily reflect those of the Institute for Research on the Economics of Taxation (IRET).

Professor David Sappington

The Commission asked Professor Sappington to review methods of regulating prices in the nation's investor-owned telecommunications industry. Accordingly, Professor Sappington devoted most of his testimony to the telecommunications industry and the positive contribution made there by price cap regulation, particularly when combined with efforts to increase competition. He briefly warned the Commission that lessons drawn from the telecommunications industry, which consists mainly of investor-owned companies, might not be applicable at the Postal Service, which is a government-owned enterprise. However, given his assignment, Professor Sappington did not attempt to flesh out the differing implications for regulation depending on whether an enterprise is owned by investors or by the government. I think that difference is crucial and would like to discuss it here.

Under rate or return regulation, a company in a regulated industry has no strong incentive to worry about its costs. Because the prices that the regulatory authority allows a firm to charge are basically set on a cost plus basis, higher costs do not especially hurt the firm; it is allowed to charge more. Conversely, unless there is a significant regulatory lag, the firm has little incentive to reduce its costs because the gains to the firm from lower costs would be offset by lower revenues as its regulated rates are cut. (Indeed, if the company is allowed an attractive rate of return, there may be a perverse incentive to bulk up its capital stock and other costs that enter its rate base in order to earn the attractive return on a larger base.)

Under price cap regulation, in contrast, an ***investor-owned*** company in a regulated industry has a powerful incentive to manage its costs carefully. This regulatory approach usually allows prices to increase at the rate of inflation, less an adjustment for expected future cost savings due to technology. (If inflation is 3% and expected cost savings due to technological improvement are 0.5%, the allowed price increase would be 2.5%. The regulated company usually also has the option of raising prices by a smaller percentage, if it wishes.) Under a price cap regime, if regulated prices and their rate of change over time are calibrated properly, the regulated prices will be sufficient to cover costs — if costs are managed reasonably well — and to provide a market rate of return. But if the company manages its costs even better, the returns will be even higher.

Thus, by separating regulated prices from realized costs, price cap regulation introduces a cost-management carrot: good cost management will boost a company's rate of return, and the company's ***equity owners*** can expect to realize the extra return through larger dividend payouts and/or a higher stock price. Price cap regulation also wields a cost-control stick. Poor cost management will depress the company's returns, and the company's equity owners will feel the pain via lower dividends and/or a lower stock price. ***Facing these incentives, the company's equity holders will push it to strive for efficiency.*** (In practice, of course, price caps are usually adjusted to reflect experienced costs, at least partially, after a several-year lag. But the lag is intended to be long enough that incentive effects are still powerful.)

It is important to ask if a private-sector company with multiple products would be tempted to engage in cross-subsidization under a price cap regime. A company typically has more leeway in varying the price of one product relative to another under price cap regulation than under rate of return regulation, and the possibility arises of undesirable cross-subsidization of one product by another. The answer, fortunately, is that ***an investor-owned company has an incentive not to cross-subsidize***

because doing so would harm its owners. Suppose a company uses profits from a regulated product to support other products that are losing money. These cross-subsidies are costs to the company; they lower its profits; and that is contrary to the interests of the company's owners. Accordingly, in striving to maximize profits, the owners of an investor-owned company will want the company to measure the costs and revenues of each product as accurately as possible and make sure each product pays its own way. (To be sure, a short-term loss on a product will be tolerated if it is expected that the loss is only temporary and that over time the product will earn at least a market rate of return.)

Regrettably, the desirable incentive effects that price cap regulation has at an investor-owned business ***disappear at a government-owned enterprise***. Why should those who control a government-owned enterprise worry any more about costs and productivity under price cap regulation than under rate of return regulation? Unlike an investor-owned company, a government enterprise does not have vigilant and demanding equity owners who would be harmed (through reduced after-cost returns) if its costs are high, or who would be helped (through higher returns on their equity investment) if costs are low. Two earlier witnesses at the Commission's February 20 Hearing, Dr. Robert Cohen of the Postal Rate Commission and Professor Michael Crew, had briefly referred to the incentive problem at a government enterprise like the Postal Service caused by the absence of residual claimants (that is, equity owners).

At a government enterprise, price cap regulation is much worse than rate of return regulation with regard to cross-subsidization. A narrow definition of cross-subsidization among products is that one product's revenues make no contribution to overhead and fail even to cover the product's attributable costs, with profits from other products being used to make up the losses. Although the Postal Service's ***own cost estimates*** do not show much of this type of cross-subsidization, a concern is that if the Postal Service is not attributing costs accurately, cross-subsidies may actually be large — but

concealed. It is worrisome in this respect that the Postal Service claims so many of its costs are institutional and have no relation to specific products. Some observers define cross-subsidization among products more broadly, and apply the term when there are great disparities among the rates at which various products contribute to overhead costs. In the context of the Postal Service, a special concern is that consumers within the postal monopoly — whose rates the Postal Service is supposed to keep as low as possible consistent with breaking even — bear a disproportionately large share of the Postal Service's unattributed costs. (For a fuller discussion of these issues, see Michael Schuyler, "Does First-Class Mail Carry Too Much Overhead?" *IRET Congressional Advisory*, No. 141, November 13, 2002, available on the Internet at ftp://ftp.iret.org/pub/ADVS-141.PDF.)

By permitting more pricing flexibility among products, price cap regulation makes it easier for an enterprise to practice cross-subsidization, if that is what it wants. This is not a problem at an investor-owned regulated business because the business's owners seek to maximize profits, and cross-subsidies reduce profits, and so are contrary to the interests of the business's owners. However, a government-owned business does not have that internal brake on cross-subsidization because it lacks equity owners. At the Postal Service, for example, if the organization's managers think there are bureaucratic rewards for expanding the organization, they will be strongly tempted to finance expansion by using revenues from the monopoly to subsidize money-losing ventures outside the monopoly.

Current-law regulatory oversight is at least a partial barrier to such cross-subsidization, but the barrier would be less if there were a shift to the more flexible inter-product pricing of price cap regulation.

Professor Sappington was asked by some Commission members whether it makes sense in the telecommunications industry to vary regulation by product. He answered that it does in that industry; products facing competition should be subject to less regulation than products in monopoly positions.

Remember, however, that cross-subsidization among products is not a serious problem in the investor-owned telecommunications industry, because the investors find it in their self-interest that the company ***not*** have cross-subsidies among products. In contrast, a government enterprise does not have equity investors to oppose cross-subsidies.

Which way would cross-subsidies flow at the Postal Service? Those who want to keep rates for core postal services low might hope they would flow from "competitive market" products to products within the postal monopoly. It is much more likely, however, that the agency would use earnings from its sheltered market, that is, products within the postal monopoly, to subsidize the products that face the strongest and most direct competition, that is, competitive market products. The enhanced pricing flexibility of price caps, often touted as a key advantage, would perversely be a much weaker guard against such cross-subsidization than the current regulatory framework.

But suppose for a moment that the cross-subsidy would indeed work in the other direction, that profits in the competitive services sector would help to hold down prices in the monopoly sector, instead of being frittered away in inefficient operations. What would it mean to have a price cap in the competitive sector? Nothing. Why? By definition, the competitive market is a place in which no firm can charge more than any other offering a similar product. They are price takers and charge the market price. That is the root of the observation that there is less need for regulation in a competitive product sector.

But in reality, while there is less need for a ***price cap*** in a competitive sector of a government enterprise, there is a crying need for alternative restraints. Since a government enterprise would have numerous artificial advantages over the competition — tax exemption, a Treasury credit line, the monopoly sector to draw on through cost shifting, etc. — a moderately ***efficient*** government enterprise would by its very nature render that portion of the market ***uncompetitive***. Its unfair cost advantages (if

not thrown away through inefficient practices) would distort the competitive outcome unless it were forced to operate under a ***price floor*** offsetting its artificial edge, or if its advantages were eliminated by ending its tax exempt status, its line of credit, etc., at least for the competitive activities.

It would be impossibly complex to separate the enterprise's competitive and monopoly facilities and activities in this manner, or (as Professor Sappington stated) to put them under different regulatory regimes. In my view, there are only two feasible means of achieving a truly level playing field. One is to eliminate the monopoly and other privileges and privatize the whole enterprise. The other is to ban it from providing the competitive products.

The Commission should seriously question why a government-owned enterprise is offering "competitive-market" products at all. The government is probably a less efficient producer than investor-owned businesses, given the tendency of government businesses to suffer from high costs and low productivity, in which case there is the danger that higher prices will be charged on products within the monopoly in order to subsidize the competitive-market products. In addition, its provision of competitive-market products raises the issue of unfair competition because its products are often exempt from taxes and many other government-imposed charges that private-sector businesses must pay when they offer similar products.

In summary, price cap regulation is a genuine advance over rate of return regulation — ***if the regulated businesses are investor owned***. Private ownership is needed in order for price cap regulation to create positive incentives to lower costs and raise productivity without increasing the danger of cross-subsidization. At a government-owned business, such as the Postal Service, price cap regulation would not improve incentives, and it would open the door wider to cross-subsidization, unfair competition, and inefficiency. Those are reasons to avoid it at a government-owned enterprise.

The Postal Service has financial problems because of high costs and lagging productivity. A

more fruitful way to address those problems would be to ease some of the restrictions that Congress has written into law or has imposed via less formal political jawboning that have sharply increased the Postal Service's labor and nonlabor costs and been a drag on its productivity.

James Campbell

Mr. Campbell provided an illuminating history of the Postal Service's evolution. In a subsequent question, though, he was asked whether government subsidies to the Postal Service should be ended. He answered that the Postal Service does not receive subsidies; it does have legal privileges. Perhaps Mr. Campbell sought to make the point that since the mid 1980s the Postal Service has not received large Congressional appropriations, that is, direct cash subsidies legislated each year as part of the federal budget from Congress.

I think it important to add the clarification, however, that from an economic perspective subsidies need not be explicit. They may be indirect and take the form of special government rules that favor one individual, organization, or group over others. A partial list of the Post Service's legal privileges that an economist would classify as indirect — but valuable — subsidies are its exemption from paying local property taxes on the billions of dollars of land, buildings, and equipment it owns; its exemption from having to collect and remit state and local sales taxes on its billions of dollars of sales; its exemption from all income taxes; its direct credit line at the U.S. Treasury, which comes with a preferential, government-related borrowing rate; its government-related protection against bankruptcy; and its exemption from state motor vehicle licensing requirements and registration fees. These hidden subsidies are worth, at a minimum, hundreds of millions of dollars annually. (For rough estimates of the dollar magnitude of several of the Postal Service's indirect subsidies, see Michael Schuyler, *The Anti-Competitive Edge: Government Subsidies To Government Businesses: Case Studies Of The*

Postal Service, TVA, And Amtrak, IRET Fiscal Issues, No. 11 (Washington, DC: Institute For Research On The Economics Of Taxation, 1999).) Of course, the Postal Service's crown jewel is its postal monopoly, which includes its statutory monopolies on non-urgent letter delivery and on mailbox use.

It is easy to overlook the Postal Service's hidden subsidies because they are not transparent; they do not appear explicitly in the federal budget. Nevertheless, they are real. Moreover, if the Postal Service were allowed to expand while retaining its legal privileges, most of its hidden subsidies would increase as the organization had more sales, acquired more property, and borrowed more. In particular, insofar as its expansion took business away from private-sector firms that now pay federal, state, and local taxes, those tax receipts would be lost, constituting an open-ended, camouflaged subsidy to the Postal Service from taxpayers at all levels of government throughout the country.