American Enterprise Institute for Public Policy Research

Postal Reform Paper No. 5 July 2004

A New Antitrust Paradox: *Flamingo Industries* and the Future of the Postal Service

By Rick Geddes

In United States Postal Service v. Flamingo Industries (USA) Ltd., *the Supreme Court decided that the postal service is exempt from antitrust liability. From a policy perspective, the ruling is disturbing for three reasons. The Court assumes that firms with goals besides profit maximization will not behave anticompetitively. Second, it presumes that the Postal Rate Commission currently has sufficient authority to control anticompetitive behavior by the postal service. Third, the Court displays a disturbing lack of concern for firms competing with the postal service in nonpostal activities. The Court's ruling in* Flamingo Industries *makes effective postal reform more imperative.*

The Supreme Court's decision in *United States Postal Service v. Flamingo Industries (USA) Ltd.* (February 25, 2004) illustrates the policy problems that arise when the government performs activities that are fundamentally commercial in nature. The Court's treatment of the problems was economically unsophisticated—but its very naïveté suggests an often-overlooked rationale for market provision of the services in question and points strongly to the need for Postal Service reform by Congress.

The issue before the Court was whether the U.S. Postal Service (USPS) is subject to the antitrust laws. The Court held, unanimously, that it is not, and as a legal matter the holding was impeccable: the Postal Service is clearly part of government; Congress could not have meant for government to become subject to the antitrust laws when it enacted the Postal Reorganization Act; therefore the Postal Service is not subject to the antitrust laws.

Embedded in the Court's reasoning, however, were three economic assumptions that are incorrect and disturbing. First, *Flamingo* asserts that government enterprises that do not maximize profits in the manner of private firms are unlikely to engage in anticompetitive conduct. This is wrong, indeed the opposite of careful economic thinking on the subject, and it establishes a worrisome dictum for the legal treatment of a variety of government-run enterprises. Second, the Court suggests that the Postal Service is not an anticompetitive threat because it is regulated by the Postal Rate Commission. Given its current limited authority, however, the commission is unlikely to be effective in controlling anticompetitive behavior by the USPS. Third, the Court dismisses concerns about Postal Service entry into nonpostal activities because those activities constitute a relatively small portion of postal revenues—a point that is highly disconcerting given the growing intersection of services (postal and nonpostal) that may be supplied by private firms, as well as the USPS.

In this essay, I consider each of those issues in detail, following a review of the facts of the case.

Rick Geddes is associate professor in the Department of Policy Analysis and Management at Cornell University and the author of *Saving the Mail: How to Solve the Problems of the U.S. Postal Service* (AEI Press, 2003). He is a research fellow at the Hoover Institution and an adjunct scholar at AEI.

The *Flamingo Industries* Case

The U.S. Postal Service's founding statute is the Postal Reorganization Act of 1970 (PRA). The PRA gives the Postal Service the power "to sue and be sued in its official name" (39 U.S.C. §401), suggesting

that it can be sued under the antitrust laws. The *Flamingo Industries* case tests that proposition.

Flamingo Industries, the party bringing suit, manufactured mail sacks for the Postal Service. The Postal Service ended its contract with Flamingo. Flamingo claimed that the Postal Service terminated the contract because it wanted to use cheaper mail sacks manufactured in Mexico that failed to meet safety and quality regulations.[1] Flamingo alleged that the Postal Service sought to disguise its actions by adopting antiquated requirements for the mail sacks, requirements that Flamingo and other modern domestic manufacturers could not meet, which created a pretense for canceling the contracts. Flamingo further claimed that the Postal Service used the contract cancellation to create a bogus emergency in mail sack supply, which allowed it to award future contracts to foreign suppliers on a no-bid basis. Among other things, Flamingo asserted that the Postal Service sought to suppress competition and create a monopoly in mail sack production. This brought about a test of the applicability of the antitrust laws to the USPS.

The Court decided that the Postal Service is immune from antitrust liability. It applied a two-step process to reach that conclusion. The first step asks whether Congress waived sovereign immunity for the Postal Service when it included the "sue and be sued" clause in the PRA. The Court answered yes, stating that "The sue-and-be-sued clause waives immunity, and makes the Postal Service amenable to suit, as well as to the incidents of judicial process."[2] This alone is insufficient to establish antitrust immunity, however. The Court said, "An absence of immunity does not result in liability if the substantive law in question is not intended to reach the federal entity."[3] The Court's second step was to determine if the substantive antitrust liability in the Sherman Act extends to the Postal Service.

To understand if the Sherman Act was intended to reach the USPS, the Court focused on the Postal Service's status as a component of the executive branch of the federal government. A key distinction here is between an "independent establishment of the executive branch" versus a "government corporation." The Court noted that Congress considered converting the Postal Service into a "government corporation," (instead of an independent establishment) in the PRA, which presumably would have subjected it to the antitrust laws. Congress rejected that option. The Court found that the USPS is part of the federal government and thus immune from antitrust liability. As summarized in the syllabus accompanying the Opinion of the Court, the ruling was that

> For purposes of the antitrust laws, the Postal Service is not a separate person from the United States. The PRA's designation of the Postal Service as an "independent establishment of the executive branch of the Government of the United States," 39 U. S. C. §201, is not consistent with the idea that the Postal Service is an entity existing outside the government. Indeed, the designation indicates just the contrary. The PRA gives the Postal Service a high degree of independence from other Government offices, but it remains part of the Government.[4]

The Court's legal reasoning appears straightforward, but it also relies on several erroneous institutional and organizational concepts to support its analysis. Left uncontested, those notions could have undesirable policy implications. I discuss three such issues below.

The Objectives of the Postal Service

Regarding the objectives of the USPS as related to its antitrust liability, the Court states:

> Our conclusion (of no antitrust liability) is consistent with the nationwide, public responsibilities of the Postal Service. The Postal Service has different goals, obligations, and powers from private corporations. Its goals are not those of private enterprise. The most important difference is that it does not seek profits, but only to break even, 39 U. S. C. §3621, which is consistent with its public character.[5]

The Court here suggests that, because the USPS does not maximize profits, it is less of an anticompetitive concern than a profit-maximizing enterprise. The Court does not explore the interaction of a firm's goals and its propensity for anticompetitive behavior. Such an investigation may have revealed that a small but growing body of research in law and economics indicates that exactly the opposite is true: government-owned firms that do not strictly maximize profits are *more* likely to behave anticompetitively.[6] Although there are a variety of reasons for this, I will only discuss several here.[7]

First, although a government firm may not value profit, it has other objectives. Good candidates include maximization of size (as measured by revenues) or some combination of size and profit. The firm may value size because the government instructs it to increase employment or to ensure that services are provided ubiquitously, or because managers get direct utility from operating a larger firm. Managers get direct utility from greater firm scale either because they believe the output itself is socially beneficial or because larger output is associated with enhanced prestige and more opportunities once they leave the firm, or both.

When a government firm values output for its own sake, it will be less concerned than a private firm with the additional costs associated with increased output. For an activity where it faces competition, the government firm has an incentive to set price below marginal cost and hold it there (even though it creates losses) because the firm values the expanded output associated with a lower price. This will drive private, profit-maximizing competitors out of business, even though those competitors may be more cost efficient.

Second, there are a variety of additional anticompetitive activities that government firms can undertake if they value expanded output for its own sake, even if the firm is regulated effectively to prevent below-cost pricing. As David E. M. Sappington and J. Gregory Sidak state:

> If prohibitions on below-cost pricing are in effect, an SOE (state-owned enterprise) will have a strong incentive to understate its marginal cost of production or to over-invest in fixed operating costs to reduce variable operating costs. A public enterprise may also be more inclined than a private, profit-maximizing firm to raise rivals' costs and to undertake activities designed to exclude competitors from the market because those activities expand the scale and scope of the SOE's operations.[8]

The above analysis suggests that the Postal Service, despite its status as a government firm, has a strong incentive to engage in anticompetitive behavior. In addition to the incentive, it has the ability to do so. The Postal Service possesses monopolies over the delivery of anything defined as a letter, as well as over the customer's mailbox. Unless it is regulated vigilantly, it can use revenue from those monopolies to subsidize activities where it faces competition.

In addition to its monopoly powers, government ownership gives the Postal Service an array of special privileges and immunities, all of which are highly valuable and can be used to under-price more efficient private rivals. For example, it is exempt from taxation. Because it can borrow from the Federal Financing Bank, it enjoys an explicit government debt guarantee. Because it is government-owned, it is exempt from paying investors an expected rate of return on their invested capital. It has, at various times, received direct cash subsidies. It has the power of eminent domain. It is exempt from a host of government regulations including SEC disclosure requirements and FTC truth-in-advertising laws. It is immune from parking tickets for its vehicles or from paying for vehicle registrations. It does not have to apply for building permits or conform to local zoning regulations. All of those government-granted benefits are valuable, and they allow the USPS to artificially reduce its prices below those of more-efficient rivals.

The above discussion suggests that the Court was hasty in concluding that the Postal Service does not present a competitive threat because it does not maximize profits. There are several additional concerns with the Court's analysis of this issue, however. The Court does not appear to be deliberating with the benefit of a coherent theory of government enterprise behavior. Instead the Court merely states what it believes the Postal Service is not doing, but it never suggests what objectives the USPS might have (aside from breaking even), and what the implications of pursuit of those objectives might be. The Court does not examine what type of incentives a break-even constraint creates, or how those differ from profit maximization. The minimization of losses, for example, is exactly equivalent to profit maximization.

Moreover, the Court ends its decision by noting that the USPS is active in some areas in which it could maximize profits, stating, "The Postal Service does operate nonpostal lines of business, for which it is free to set prices independent of the Commission, and in which it may seek profits to offset losses in the postal business."[9] The notion that the Postal Service might maximize profits in some activities but then shift objectives when undertaking a different activity flies in the face of economic theory. There is no evidence of firms acting in that manner. By not considering a consistent theory of government enterprise behavior and its relationship to anticompetitive conduct before opining on potential

harms, the Court has placed dangerous conjectures in its opinion. It also clouds the Court's views on other matters, such as the importance of energetic regulation of the Postal Service, as discussed below.

Regulation of the Postal Service

In supporting its decision to insulate the Postal Service from antitrust liability, the Court states that the USPS

> lacks the prototypical means of engaging in anticompetitive behavior: the power to set prices. This is true both as a matter of mechanics, because pricing decisions are made with the participation of the separate Postal Rate Commission, and as a matter of substance, because price decisions are governed by principles other than profitability.[10]

The passage is noteworthy for several reasons. First, the Court has here moved on to suggest that the lack of profit-maximizing objectives implies that the firm is not only harmless from an anticompetitive perspective, but also need not be so carefully regulated "because price decisions are governed by principles other than profitability." Again, the Court does not state what principles do govern the Postal Service's pricing decisions and how those differ from profit maximization. Because it does not consider a model of government firm behavior, it is unable to systematically consider the firm's propensity for anticompetitive behavior. As we have seen, plausible objectives of government firms suggest that they are more likely than private firms to behave anticompetitively.

This passage is also noteworthy because of its treatment of postal regulation. The wording used, " . . . as a matter of mechanics, because pricing decisions are made with the participation of the separate Postal Rate Commission . . . " is curious. A customer might be disconcerted if her electricity were priced "with the participation" of the separate state public utility commission, as opposed to being *set by* that commission. A regulated firm and its regulator are not normally thought of as co-participants in the process. Regardless of whether or not the wording belies lack of confidence in the Postal Rate Commission's authority, those powers are unlikely to be sufficient to control anticompetitive behavior.

I have pointed out the weakness of the Postal Rate Commission in detail elsewhere.[11] The commission was established not to set postal rates but to recommend rate changes to the USPS Board of Governors after the Postal Service requests a rate change. The Board of Governors may overrule the Postal Rate Commission, provided the Board is unanimous. The Board has in fact overruled the commission in the past and implemented its desired rates. Final authority to set rates lies not with the regulator but with the Postal Service itself.

Crucially, the commission has no control over the Postal Service's revenue requirement, which is based on its costs. The Postal Service is itself able to determine the overall level of rates. The commission is able to allocate those costs across the various mail classes, but the commission has little power to constrain the overall costs of the Postal Service.

The commission also does not have the power to regulate the quality of postal service or to compel document production from the Postal Service, which means that the quality of financial information it receives is often poor. The commission is also weak because of government ownership itself. A public utility commission regulating an investor-owned utility can use the compelling threat of reducing equity value through lower rates to gain leverage over the firm. The regulator of a government firm by definition is unable to reduce equity prices.

These are obviously severe constraints on the commission's ability to police anticompetitive behavior by the USPS. The Court is therefore wrong to assume that, without the benefit of antitrust liability, that the commission will be effective in that endeavor.

Nonpostal Activities

Another area of concern is the manner in which the Court deals with entry by the Postal Service into "nonpostal" lines of business. The Postal Service has recently expanded into a variety of activities outside its core function of delivering mail, including retail sales of mugs, tee shirts, phone cards, Direct Mail services, passport photos, and a variety of e-commerce services such as eBill Pay, NetPost Cardstore, digital stamps, and NetPost Certified Mail. Those ventures have caused great consternation among the private firms competing with the Postal Service in such services.

Yet the Supreme Court appears either unconcerned or unaware of the damage such nonpostal ventures have caused. To extend the quote above from the Court's decision, "The Postal Service does operate nonpostal lines of business, for which it is free to set prices independent of the commission, and in which it

may seek profits to offset losses in the postal business §403(a). The great majority of the organization's business, however, consists of postal services . . . Further, the Postal Service's predecessor, the Post Office Department, had nonpostal lines of business, such as money orders and postal savings accounts."[12] There are several reasons why such a benign view of nonpostal activities is misplaced.

First, the Court's decision reveals a lack of concern for businesses competing with the USPS in nonpostal activities. It dismisses nonpostal activities as being unimportant because they are a relatively small portion of postal revenues. Yet even one percent of postal revenues amounts to over $680 million. That may be a substantial threat to a small startup company competing with the USPS, or even an established medium-sized firm. Moreover, the Court does not indicate where the threshold of concern in nonpostal activities lies. Would $2 billion in nonpostal revenues be a concern? Would $5 billion?

Second, given the limitations in the Postal Rate Commission's powers noted above, the current uncertainty over the commission's authority to regulate nonpostal activities, and even what defines postal versus nonpostal activities, it is unlikely that those activities will be effectively controlled absent antitrust liability.[13] The Postal Service appears free to enter any activity it wishes and to charge any price it wishes, and it will likely use resources from its monopolized activities to cross-subsidize nonpostal ventures. Uncertainty surrounding regulatory control over the Postal Service's offering of new, nonpostal products, and its pricing of them, is likely to deter small business from entering any related services.

Third, a General Accounting Office report indicates that the Postal Service actually loses money on its nonpostal activities, but that USPS cost accounting for the services is so poor that it is impossible to measure the size of those losses with precision.[14] The Postal Service is thus not offsetting losses in postal activities through these ventures, as the Court suggests, but instead is draining resources from them. If the USPS is in fact losing money in its nonpostal activities, then it is effectively cross-subsidizing nonpostal activities with revenues from monopolized activities. That is obviously damaging to small business competitors, but it is also harmful to captive customers who must pay higher rates in the Postal Service's core business of letter delivery.

Finally, the Court seems unaware that "nonpostal" activities have historically referred only to services provided by the Postal Service to other federal government agencies.[15] The Court does not note this crucial point and appears instead to concede to a new definition of nonpostal services as completely new business ventures unrelated to traditional postal services. There is a risk that this decision will promote an incorrect interpretation of the meaning of nonpostal services.

Calling on Congress

I began this essay by noting that the *Flamingo Industries* case illustrates the inherent contradictions that arise when government performs activities that are fundamentally commercial in nature. The Postal Service is a $68 billion company with 827,000 employees, about 38,000 retail postal outlets, 446 mail processing facilities, and 215,000 vehicles, which operates several business lines. It has a legally enforced monopoly in its core business and receives numerous government-granted privileges and immunities. Yet it is exempt from the antitrust laws, SEC disclosure requirements, and truth-in-advertising laws. If the antitrust laws are valuable in preventing the abuse of market power in other industries, it is unclear why they would not be beneficial in postal services as well. The decision in *Flamingo Industries* may well be inevitable given current institutional arrangements, but it makes for bad policy and opens the door to potential abuse.

Congress is now considering reform of the U.S. Postal Service. The decision in *Flamingo Industries* makes robust postal reform even more imperative. Congress should consider ways to adapt reform legislation to this antitrust exemption. Strict limits on the Postal Service's monopoly powers or elimination of those powers should be understood as helpful not only in enhancing efficiency but also in reducing subsidization of nonpostal activities. Congress should also expand significantly the powers of the Postal Rate Commission, giving it final authority to set rates, to gather information, and to control what products the Postal Service offers. *Flamingo Industries* also suggests that Congress should require the Postal Service to focus only on its core activity of mail delivery. If the USPS truly has a public service mission in the delivery of mail to all addresses, then diversification into unrelated (and, as best we can tell, money losing) nonpostal activities is a distraction from that core function. The Supreme Court's decision in *Flamingo Industries* is yet another admonition that the time for muscular postal reform has come.

Notes

1. *United States Postal Service v. Flamingo Industries (USA) Ltd.*, Petition for Writ of Certiorari, May 27, 2003. Available at www.lunewsviews.com/usps/mailsacks.htm.

2. Flamingo's allegations were obtained from *United States Postal Service, Petitioner v. Flamingo Industries (USA) Ltd. et al.*, Opinion of the Court, 7.

3. Ibid.

4. Ibid., Syllabus, 2.

5. Ibid, Opinion of the Court, 9–10.

6. See e.g., John R. Lott Jr., "Predation by Public Enterprises," *Journal of Public Economics* 43 (1990); David E. M. Sappington and J. Gregory Sidak, "Incentives for Anticompetitive Behavior by Public Enterprises," *The Review of Industrial Organization* 22 (2003): 183–206; and R. Richard Geddes, ed., *Competing with the Government: Anticompetitive Competitive Behavior and Public Enterprises* (Stanford: Hoover Institution Press), 2004.

7. For more detail on this point, see Rick Geddes, "Opportunities for Anticompetitive Behavior in Postal Services," AEI Postal Reform Paper #3, June 2003.

8. David E. M. Sappington and J. Gregory Sidak, "Anticompetitive Behavior by State-Owned Enterprises," in Geddes, ed., *Competing with the Government*, 5.

9. *United States Postal Service v. Flamingo Industries*, Opinion of the Court, 10.

10. Ibid.

11. See Rick Geddes, *Saving the Mail: How to Solve the Problems of the U.S. Postal Service* (AEI Evaluative Studies, 2003), 35–40.

12. *United States Postal Service v. Flamingo Industries*, Opinion of the Court, 10–11.

13. The Postal Rate Commission is deliberating over two relevant rulemakings, one on the definition of nonpostal activities and the other on the reporting requirements for nonpostal activities.

14. See, e.g., Government Accounting Office Report GAO-02-79, *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections* (December 2001), available at www.gao.gov/ new.items/d0279.pdf.

15. See "Petition of Consumer Action Requesting that the Commission Institute Proceedings to (1) Review the Jurisdictional Status of Fourteen Specified Services and (2) Establish Rules to Require a Full Accounting of the Costs and Revenues of Non-Jurisdictional Domestic Services," Petition for Review of Unclassified Services, Before the Postal Rate Commission (October 15, 2002), 3.