



The Daily Dish

Markets as Political Mechanisms

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Eakinomics: Markets as Political Mechanisms

Many are befuddled by economists and policymakers who favor private-sector market mechanisms over government programs. To understand the benefits of the market, let's think about bagels.

Making bagels costs money, and as one makes more and more bagels, those costs are likely to rise. After all, you might need to staff 24 hours a day, requiring higher wages. You'd also likely need a bigger physical footprint — kitchen, storage, delivery, etc. — which would drive up costs as well. At some point, those additional costs per bagel (labelled marginal costs) will exceed the price, and it is a losing proposition to continue. Notice that the costs arise because the bagel-maker has to lure scarce resources — people, equipment, etc. — away from other activities. So bagel production continues as long as the price covers that cost of giving up those alternatives, but no more.

On the other side of the transaction, the benefit of bagels (the marginal benefit) likely declines as you eat more and more of them each day; I generally find that once you get to 18 or 19 it's just not worth the price of another bagel, and I call it quits. Again, the benefits of bagels are relative to eating muffins or donuts or whatever, so bagel consumption continues as long as the marginal benefit exceeds the price, but not more.

Here's the magical part. At the point when production ceases and consumption ends, the marginal cost and the marginal benefit both match the price, and thus each other. A political miracle has occurred. A vast society of people with very different incomes and tastes agree unanimously on the value of the final bagel they consume — it's the price — and that value exactly compensates for the cost of giving up the alternative possible products — it is also the price. Notice, as well, that the same magic is occurring simultaneously for every other product on the shelves — pickles, cereal, toys, whatever.

It is impossible to imagine holding a vote of some sort to get to an agreement — much less unanimity — on how much to produce and charge for every product, and then issuing the orders to get it done. (This, by the way, is why the Soviet Union is no more.) Markets are a very effective political mechanism.

There are other political virtues as well:

1. Freedom. You don't have to participate in the bagel market. With government programs, however, you might have to vigorously participate to not be involved.
2. Values. Notice that the "benefits" assigned to additional bagel consumption are those of individuals. Society's value reflects the values of citizens. This isn't some top-down, dictatorial approach.
3. Innovation and Diversity. Personally, I'm dull. My favorite bagel is plain and unsliced with no toppings whatsoever. You might notice, however, that there is an ever-increasing variety of innovative new bagels that provide a closer matching of products and tastes (and higher value). If we did bagels as a government program,

there would be a rulemaking on what constituted a bagel. The regulatory apparatus would be used by incumbents to keep out entrants and to stifle innovation. Even worse, imagine a ballot initiative being required to get approval for a pumpkin-spice-garlic-raisin bagel!

4. Incentives and Discipline. The ability to make a profit provides powerful incentives to meet the bagel tastes of the citizenry at the least possible cost. And, equally important, use of the market mechanism produces the demise of those who do not respond to the tastes of the customers and keep costs under control. Since failure is bad news for somebody's constituent, however, the government-program mechanism tends to try to rescue those laggards.

There are good reasons why markets are the best political mechanism in the vast majority (but admittedly not all) situations.