In Sync: How Business Responds to Gratis Government

Whenever people criticize government provision of a product, clever analysts often demur that private suppliers who compete with government have exactly the same problems. Part of Helland and Tabarrok's case for the Baumol effect in education, for example, is that prices have risen at the same rate in both the public and private sectors:

> *Prices are much lower at public than at private institutions. The vertical scale is a ratio scale, so equal slopes mean equal rates of growth. Thus, although prices are lower at public institutions, the rate of growth in prices has been similar at private and public institutions. Between 1980 and 2015, real prices more than doubled.*

OK, let's step back. Picture a typical government service. The price: gratis. The quality: mediocre. Private competition, however, remains legal. Should we expect the private part of the market to look just as it would under laissez-faire?

No way. Unless the government rations the free mediocre product, consumers have virtually no reason to ever pay for products of mediocre or lower quality out of their own pockets. At minimum, then, government's gratis products kill private production of all products of equal or lower quality – a textbook case of predatory pricing.

That's not all. Gratis production also effectively kills private provision of products of *moderately* higher-than-mediocre quality. After all, if you can get a C+ product for free, who wants to pay full price for a B- alternative? With gratis public provision, private providers must convince consumers that the *marginal* quality improvement is worth the *total* price of the product. A tall order.

What does this mean? Well, if public schools add more low-value services, private schools must keep pace in order to compete. If public schools add more sports, more specialized teachers, or more courses, private schools that fail to keep up will lose their customers. The first rule of private competition against gratis government is: Always keep your product quality well above the government's. This remains true even if the government adds services that consumers value well below cost. If you can get them for free from the government, why pay extra for a private school that refuses to offer them?

The lesson: When government supplies free (or highly subsidized) products, *we should expect private suppliers to supply gold-plated versions of the standard government-issue*. As a result, their prices and costs will be closely synced.

There are admittedly some exceptions: If government is spending money for *no gain at all*, private competitors needn't bother. If government supplies numerous expensive low-value services, private competitors might decide to just outshine the government on other dimensions. Most realistically, if government *refuses* to provide some cheap, highly-valued options (such as religious education), then private competitors can win customers by filling the gap.

Yet overall, when there is a dominant public sector with a private fringe, we should expect the Helland-Tabarrok pattern – without or without a Baumol effect. Given the pathologies of the public sector, it's nice to have a private option, but don't get too excited. The private options will generally be extravagant, because gratis government strangles budget-friendly alternatives. Tragically, this in turn sustains the illusion that in the absence of government, only the rich would be able to afford whatever the government now provides.

P.S. Another reason to expect public and private education to closely resemble each other is that both are almost always non-profit. Morally, yes, there is a major difference between public and private non-profits. Economically, however, they're very much alike, because both give managers flimsy incentives to raise value or cut costs.