Secondary Markets:
The Quiet Economic Value Creator*

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Ah, that new car smell! The phrase alone conjures up satisfying images of driving your shiny new baby off the lot and down the highway while watching the odometer rack up its very first miles. By contrast, the phrase “used car smell” conjures up either nothing or something generally unpleasant. The economy, however, being largely indifferent to smell, benefits from both new and used goods changing hands.

New goods contribute to important measures of production, such as GDP. Many products, however, continue to create value long beyond the date they were created, both to the original buyer and later to others when the original buyer resells the good. As a result, maximizing our economic well-being means not only maintaining strong institutions that help increase GDP, such as incentives to build new factories, but also ensuring that secondary markets can function well.

Indeed, with every non-coercive sale in a primary or secondary market a good is transferred from a seller who values the good less than the transactions price to a buyer who values the good more than the transactions price. The result is that economic value is added for both the buyer and the seller. Moreover, while each party benefits from the exchange, the larger society also benefits due to the allocative efficiency produced by the transaction. While economic indicators fail to capture this new consumer surplus, these efficiencies will, over time, be reflected in measurable economic activity. Consequently, if policies inadvertently or arbitrarily hinder the development and functioning of secondary markets, we will lose not only immediate consumer benefits but also
the measurable economic effects that will result later from transactions that move goods from lower-valued to higher-valued uses.

**The importance of secondary markets**

Despite the importance of secondary markets to economic welfare, these markets have received relatively little economic scrutiny. This relative inattention among micro and macro economists is puzzling given that the magnitude of economic value creation in secondary markets in the United States is billions of dollars annually. Consider for instance the secondary market for housing. Figure 1 shows the number of new (in red) and existing (in blue) home sales in the United States over a fifty-year period. Sales of existing homes in the secondary market are dramatically larger than the number of new homes produced and sold in any given year. While the average value of a new home sale exceeds the average value of existing home sales, the total size of the secondary market for housing was fully twelve times larger in 2010 than the market for new homes. Indeed, it is practically impossible to imagine our economy without secondary transactions for housing. Home ownership would likely be nonexistent if buying a house meant becoming permanently connected to such a large asset and locked in to a specific geographic location.
Another vivid example is the car market. Figure 2 shows that the number of used cars sold (in blue) in the United States is significantly higher than number of new cars sold (in red) in each year.

As shown in Figure 3, even after accounting for the higher value of new cars relative to used vehicles the value of sales accounted for in the secondary market in any given year is roughly equal to that of new cars. For example, in 2009 the value of used car sales was $301 billion, more than the value of $274 billion reported in new car sales.
At one time, the used car market was the infamous example of George Akerlof’s “market for lemons.” Inefficiencies in this market were thought to arise because sellers had no credible way to signal the true quality of the car to potential buyers. Consequently, owners of high-quality used cars were thought to have less incentive to sell than owners of low-quality used cars. In response to this problem, states passed “lemon laws,” dealerships established certification programs and offered warrantees, and services like Carfax emerged that allow buyers to check a car’s history. These new institutions have made the used car market more efficient and increased its contributions to economic well-being.

The vital role of secondary markets in the United States is also reflected in primary and secondary market sales of aircraft and in their respective valuations. As seen in Figure 4, secondary market transactions for aircraft are roughly three times larger than are initial sales of aircraft. As pointed out in a recent paper by Allesandro Gavazza, this active secondary market for aircraft emerged in the
wake of airline deregulation, which generated a growing demand for airlines that could flexibly adjust capacity to evolving retail-level market conditions.

Figure 4: Transactions in the Primary and Secondary Markets for Narrow-Body and Wide-Body Aircraft

And while initial manufacturing of new aircraft has a large and measurable effect on GDP, $52 billion in 2009, the total contribution of aviation to GDP, was about $728 billion. Figure 5 shows that the number of aircraft departures in the U.S. more than doubled from 1975 through 2008—a trend that surely would not have been possible without an active secondary markets for aircraft to satisfy the evolving needs of airlines and their customers. Thus, even though the secondary trades themselves may not show up in the economic statistics the same way new aircraft production does, their economic effect is clear.

Beyond these large and visible examples, secondary markets quietly pervade our economy. Secondary markets enable the flow of resources from lower-valued to higher-values uses across a broad swath of industries ranging from capital equipment to financial instruments to virtually everything sold in garage sales and flea markets across the country every weekend. Moreover, the importance of secondary markets as a share of economic activity has grown with the proliferation of secondary market facilitators on the Internet. Ebay’s nearly $10 billion in annual revenues, for example, is almost entirely due to its ability to capture just a small fraction of the value created by the secondary trades it enables.

The palliative qualities of secondary markets extend beyond the more obvious value-enhancements for buyers and sellers in well-functioning markets but also to markets in which either public or private market restrictions have distorted competitive market equilibria. For example, it is well-established that
secondary markets may arise when primary market sellers engage in price discrimination. Such secondary market activity reduces or eliminates the ability of firms with market power to selectively charge differentially higher prices to subsets of consumers who may have greater willingness to pay than other consumers. Similarly, absent governmental bans on resale, secondary markets may allow market corrections in the face of governmental policies such as price controls that create situations of excess demand.

Yet another benefit of secondary markets arises for goods that trade initially through auctions. Specifically, despite efforts at efficient auction design mechanisms the possibility of inefficient allocations of resources in the wake of auctions persists. In such circumstances, secondary markets serve at least two useful economic functions. First, secondary markets enable the flow of the inefficient initial auction-based allocations from low-valued to high-valued uses. Second, in the presence of bidders who are uncertain about the ultimate value of the item being auctioned, the ability of post-auction resale deepens the initial auction by attracting more bidders than would exist in the absence of a secondary market.

**Conclusion**

In the face of the many economic benefits of secondary markets in the economy and the large size of these markets it would seem that they would attract attention by economists, businesspeople and policymakers alike. The reality, however, is that policy discussions of secondary markets are much more the exception than the rule. Occasionally, policy debates arise regarding the

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economic welfare associated with either private or public restrictions on secondary market transactions. For example, while it is generally conceded that sales in secondary markets are value enhancing, many localities ban the resale of concert or sporting event tickets as unwarranted “scalping.” Similarly, some states have imposed price regulations to control the sale of life insurance policies in secondary markets. And, the Federal Communications Commission historically decreed that spectrum designated for one use could not be resold in secondary markets to firms hoping use the spectrum in a different manner. Whatever the reasons for creating those restrictions on secondary sales, they surely reduce economic welfare by blocking negotiated agreements between willing buyers and sellers. Accordingly, policies that enable the growth and development of secondary markets are likely to serve to the nation well as we seek to promote both the competitiveness and expansion of economic activity in the U.S.

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3 See Depken (2006).
4 See Bhattacharya, Goldman and Sood (2004).
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