

## **EEP100 Lecture 19 (Nov 3, 2009)**

### **David Zetland**

Alright folks let's get started. You all have a nice Halloween? Good Halloween? Yes? No? Who still has candy leftover? You gave it all away to the kids right? Okay. Let's get started.

What was the thing? I had something about logistics that I can't remember.

So office hours today at 12:30. There's something else I forgot. The videos are all rolling around as usual.

The syllabus...at one point during the midterm feedback that I asked you guys for...more than one person said...I wish we could have notes ahead of time, that was a very common idea...and I already told you how hard that is, because I don't have the notes ahead of time. And the other thing was...what are the topics going to be?

And I've been keeping the syllabus up to date, as far as the topics I'm talking about. And when I prepare for the lecture, I look at the four words on the syllabus and that's almost what I write on this paper.

So in terms of notes ahead of time, you will know ahead of time doing that.

If you really do want to prepare for the lecture, go to the syllabus, go to Wikipedia, look up principle agent, and read that entry. That'll get you a start on whatever the jargon is.

That might be handy for people that do want to have some notion of what I'm going to talk about before I talk about it.

*With the syllabus, I think you sent out...is the briefing #2, the peer grade, is due on the 8<sup>th</sup> of December.*

The grading will be due on the 8<sup>th</sup> of December.

*That means we have to...*

Hand in.

*Because the 8<sup>th</sup> of December falls in the RRR week? So do we just have to send it in by e-mail, or...*

We have class on the 8<sup>th</sup> of December

*We have class?*

It's a lecture but there's no new material. So you should show up, but it will be like a review session. And we might be dunking for apples for all I know. I know there's going to be no new material there. I already prepared it that way before the semester began. If you...you're all adults...if you want to show up and hand in your grading on the peer review that's fine. If you want to walk away after, that's fine.

Does that answer your questions? Any other open questions? Stuff?

I'm going to get to the briefing grading, which is an interest to some of you, in a minute. Any other questions not related to that?

Auction update. The auction we ran...I had a great time spending that \$2.75 last week. Wow, it was a party.

I put the video...the three minutes and 45 second video...that last all-pay auction on my blog, and I sent it to some people that are more famous than me and they posted it, and now it has 4500 views since Monday. So that was pretty cool. I was ecstatic. That might be one of the best things that you'll learn in this class, even though it cost some of your compadres \$2.75.

But I do want to you remind you that that all pay auction is an example of one type of lobbying. And that's what I mentioned.

It's the kind where you've got...like the Sacramento delta. That kind of lobbying, where you have two groups, or three, or four groups, that are all lobbying the politicians who are sitting there saying, oh yes. Give me your donations, and I'll listen to you. Oh yes, give me donations; I'll listen to you. That's the all pay aspect to it.

A much more common type of lobbying that we're all used to is when the farmer states and the corn states...they go to their senators, and they say: "Give us money from the other citizens," and the senators say, "Here you go." That kind of lobbying is the typically, special interest group lobbying that you're going to be discussing in your briefing, and also the type of lobbying that is much more common...that we're much more used to seeing. It's the kind that Wall Street is doing as far as executive compensation. We give you...and somebody actually figured this out with the Department of Agriculture...when I think the donation is something like, if you give \$1 to a politician in campaign contributions, you get back over \$100 of pork. In terms of the transfers from the general taxpayers to those special interests.

So the reason that lobbying is so prevalent is because there's a whole bunch of people that are making a killing off of us, the people. The biggest goal in this briefing #1, and maybe the biggest goal in this class, is to convey to you the importance of this and how it affects our policies. Including environmental policies, in which many of you care about. Including oil or resource based policies. So the government as a means of redistributing wealth, which is why we have government, can get out of control very quickly. And there's almost an infinite number of examples of the government getting out of control.

So that's what that all pay option was not necessarily about...I mean it's not the whole idea of lobbying, but there's different types of lobbying. There's the lobbying of one special interest group that is going to lobby for themselves at the expense of the general population, which is the logic of collective action, and there's the other type of lobbying, which is special interest groups that are competing over things, right? The debate over the medical health bill. What do they call it now? Health care reform. The debate over health care reform has got different groups fighting with each other. You've got AARP saying that the seniors need more money. You've got the Child Act...saying children need free insurance. You've got the Northern Scandinavian Brigade saying you need a one payer system. You've got the pharmaceutical companies saying, "We need more money."

And in the middle of this scrum of lobbyists are all these politicians that are just sucking it up. Hopefully what emerges from that, in a sense, is something that serves us all. But on the other hand, it might serve a whole bunch of special interest groups and not us; that's the problem with politics because of that monopolistic power of government.

Whatever law does finally emerge, you don't usually have an option to change...to go somewhere else and not be under that law.

There was something that I was reading the other day. The director of...Cameron? He did *Titanic*? And he's doing *Avatar*, the new film? James Cameron? I read this profile of him, and he was applying for US citizenship, and when Bush won the 2004 election, he voided his application, right? So unless you can change countries, it's difficult to get away from political themes that you don't like. So that's just a little more commentary on the importance of political policymaking.

As I mention its all auction week for me. And I've got some stuff closing up on eBay tonight. And I'm very excited to see people buying these watches. But the only reason that I want to tell you this is...it's kind of funny, actually...I started these auctions...who's done an auction on eBay? Who's set a reserve price on their auction? Why did you set a reserve price?

*Because I wanted at least that amount.*

At least that amount, right? Now let's talk about supply and demand, right? You're the supplier. And there's other suppliers that are competing with you, for example. Unless it's like a Picasso, right? So you're asking...if you say, "I want a reserve price for this much", but what if the market demand is not there for you reserve price?

*You lower it based on that auction, and just resell it, having a lower reserve.*

You lower the reserve. So the question actually...so what I would think about setting a reserve price is...in a sense that's how much you value that item to yourself. If you don't give me \$20, I'd rather keep it. That kind of item. So if you set a reserve price with that logic, that makes a lot of sense.

But I was like...I've got to get rid of these watches. They're all dead in my drawer. So I set 99 cent reserve prices, or whatever, starting prices. And now one of them is up to \$36 and \$34. But this is just (I think) the strategy I use for eBay. It's kind of an interesting thing in dynamics of markets. It's that 99 cents...most people are like, "Ooh, watch for 99 cents. I'll bid on that"

But if I said \$35, where it's already at (\$36) then a whole bunch of people would have never looked at that auction, right? So it's important to kind of keep that in mind, and as far as I was concerned, it's like the market will determine what my watch is worth. Including 99 cents.

I'm going to sell at least one for 99cents. Anyway, that's more auction stuff that's been going on. Anything else on auctions?

I can move along to the next topic. The briefing stuff.

So the briefing grading got some people a little agitated. And I'm going to try and discuss the various issues here. But let me start at the start, which is that...number one, we all agree that you're doing a briefing.

Number two, we all agree that they all have to be graded. Everybody on the same page as far as that's concerned?

Now they can all have 10s, like your blogposts, so then the problem is that...you have this problem of the quality of the grader. Who is the grader?

And grading written briefings essentially has to be...probably one person, and we might be able to divide it between the three GSIs...or the two GSIs and me. But the goal, my goal, is to have peer grading, to have you guys grade each other. So in a sense, that's out the door because that's my goal. And the reason it's my goal is because I want you guys not only to be writing for each other, but also I want you to be on the flip side of that page. I want you to think like graders. I want you to think like analysts, and critical reasoning people. So it's not just like...oh I wrote that and now I'm done...what I want you to do is analyze three other students, or three of your colleagues' papers. And then be able to give them critical feedback. That's why you are handing a written evaluation of each person's briefing. Is everybody clear on that right now? I think...I don't know if I set a limit on the evaluation, but let's just say that's one page also. I'm not interested in 15 pages of why that person can't spell.

For each one. So in a sense, you'll hand in on page, and you're going to have to write three more pages grading each others' papers, so the grading might be more work, if you want, but more words or more pieces of paper.

What you're going to do...what I suggest you're going to do...okay hold on a second.

Now the problem is with this system of peer grading is that...say you're mister nice guy...like all these guys are great. That's a 10, that's a 10, that's a 10.

And you're really mean or hard. And a 2 and a 3 and a 4. We have to be able to control for the heterogeneity among graders. Now, there's different ways of doing that.

I could say you have 20 points total to distribute among the three papers; do it any way you want. Then you might get a 10...or what do you call it...an 10 and a 5 and a 5...or a 10 or a 9 or a 1.

That could happen, but what I want to do is to impose more structure on the grading. That's why I said 1<sup>st</sup>, 2<sup>nd</sup>, and 3<sup>rd</sup>, or, more importantly...9, 7, and 5 points, which is the equivalent of 1<sup>st</sup>, 2<sup>nd</sup>, and 3<sup>rd</sup>.

I don't want to give you guys the discretion of points these papers get; I'm giving you the discretion of deciding which of the three are better relative to the other two that you're seeing. So...now some people are worried...well, wait a second, what if my amazing paper, which is what you're all going to write, goes to three people that have no clue about how great I am, and they give me 5, 5, and 5. I get the lowest point on each time. That, I think, is the fear of some people. And it's hard to...that is actually a theoretical possibility, but it's an actual not so likely situation. If you have a good paper, and it goes to three people, and those three people are comparing your paper to essentially 6 other papers (everybody understand the math here?)

then...you know...if they decide that those six papers are all better than your great paper, then maybe the person who's got a problem is you, as far as how great your paper is.

So in some sense, you have to be able to trust the other students, and the fact that they have good judgment. On the other hand, life isn't fair, and people are judging you all the time, despite the fact that though you don't deserve it.

So I'm hoping is that when there's three versions of your paper instead of just one version of your paper out there, that, on average, you'll get a grade that's more fair than not fair. Does that make sense?

Does anybody have a better idea of how to run this metric through? Or different comment or different idea?

*The only thing I'm worried about on the grading side of it...what if you get three papers that are pretty equally close. And one person ends up getting a 10, and the other gets a 5, when maybe there really wasn't that much a difference. So...how you decide which one. And then...I thought...if the grading scale wasn't like that, that you can just decide on your own if they get a 10 or a 7. Then we have to justify our writing to you and the GSIs. Then you could use that to avoid...that'll give some of...*

That's a good point. And here's what I would suggest. What I would suggest is that if you have to split hairs or flip coins, even, to decide between first or second place, then do that, and then write that on your written grading. What I'm going to do when I'm looking at your written grading, I'm going to cross correlate not only what you write, but what other people write about each paper. It's going to be a complete nightmare for us as the graders. Oh...90 papers? That's too much. Give me 270 papers. That's much more fun, right? So the GSIs and I (unfortunately I'm going to enlist them in this endeavor)...but what we're going to do is we're going to cross check what you say about a given paper against what other people are saying about that given paper.

And let's say it this way. I have the ability to override my own rule if it seems like it makes sense. I'm not a rigid idiot as far as this stuff is concerned. This is not the DMV. So does that address your concern?

I would mention that explicitly in your write up on the paper. If you say...I'm giving this (whatever) first place. We'll have to agree on a jargon. But if you say...I'm giving this second place, but it's really good. It's almost just...I would really give it...you can go ahead and write that in.

And make that in less than a sentence, and at the top. And then you're essentially going for arbitration by us. And once we see the results we'll take all that stuff into consideration as far as what to do. Another question? Yeah.

*I guess...and this would definitely be more work you, but one thing I think you could do is to have the peer grading and also have you and the GSIs read the papers*

Oh, we will be seeing everything.

*Because I was thinking if your scores are factored in, like if you a 5, 7, or 10...*

Oh you mean we actually score them as well, so there's a fourth score? No I'm going to defer to your judgment on grading, but we might have some wiggle room as far as stuff is concerned. When you hand in your grading on stuff, staple the original behind it.

I'm going to make notes because I'm going to do the protocol here.

Now the other thing is that everybody should know that when you bring this in next Tuesday, you will bring three copies. And you will put your last four in the upper right corner. If I get mean, then I might reject anything that doesn't meet that criterion. Okay? Just keep that in mind.

The last four of your SID, yeah.

*I feel like the grading of 5, 7, and 10 is kind of too harsh. I think the 8, 9, and 10 is still good.*

It's 5, 7 and 9 by the way. A little grade inflation already. Sorry.

So it should be like 10, 9, and 8.

*Yeah. Close together. Because I feel like...*

Actually maybe like 9 ½, 9.75, 10. I have to set it somewhere. It's reasonably arbitrary. I could make it worse. It could be 9, 6, and 3. So, in a sense, you're getting a 5 for turning in crap.

If you do better than average, then you're going to get a higher grade.

*Did you say 9, 7, 5?*

Yeah.

*So no one can get a...*

That's my wiggle room. If somebody comes in with three 9s, then we'll probably bump it up to a 10. Or if they...I don't even know. We have to grade the grading too.

*Is it all text, or can we put a graph on it?*

If it fits in a page, you can throw a graph. You can put a one page graph if you feel like it. Picture's a thousand words, right? And 250 words on a page. So you can go ahead and do that. You can do as many graphs as you want. If the graders can't read it, and they give you 5, then that's cool. But...you know...it's...by the way...the funny thing is...there's all this kind of uproar...oh my god the grading...but like...this is the world's hardest assignment. Did anybody notice that? Okay.

So no complaints about that...cool! It's like...hey let's go to the moon! But wait a second, what are we going to eat! Now, come on you guys, this is small potatoes.

*Does it have to be within a state, or can it be with in a city, or to the university, or...*

You can use any example of any policy situation, any polity situation (city, state, or federal) you want to. It has to obviously be clear to your readers.

*So it has to be a polity that is currently in place?*

It could be a general principle on how to fix this globally. And the reason why I gave you the world's hardest assignment is because what has been observed many times in the past is that young folks who don't know better come up with the best ideas. I, personally, am desperate for new ideas. So among the 90 of you, I'm hoping that like the Nobel Prize emerges out of this essay, and it's not going to be me collecting it. So, just keep that in mind.

*So my question was...you have to approach this as kind of a campaign manager, or like is that correct?*

The question is...how do you...so there's some elected politician who you're giving advice to, who's going to face reelection in less than two years. That's kind of the implicit situation, but that's...keep that in mind in terms of framing your presentation.

*Okay so when I read the assignment (I read it a bunch of times) it seemed like you were looking for something...like you had this secret solution that you're looking for?*

No.

*It's just a really hard question?*

Yeah.

*Okay.*

"Be a nice person" is not an answer for that.

*You can make up a totally fictional...*

Yes you can. You have one page to do it. So, I mean, don't go off into fantasyland and...you have 3 words left at the end to give your solution.

Don't define a new currency and a new measurement system.

*Does this briefing require us to read Micromotives?*

*Micromotives and Macrobehavior?* No. I suggested like...quick, read *The Logic of Collective Action*. You have to read it anyway, and it really matters for this assignment. You don't have to...don't sit there and say, "Works Cited, Mancur Olson." This is a briefing. Politicians don't read books, right? They worry about briefings. So don't worry about works cited. Just...if you have to...I mean...if you actually...besides outright plagiarism, if you take ideas, just go ahead and write through fluidly. But don't drop jargon in, because then it will be like...and you, also, as graders will be like, "Jargon! I don't get it!"

I have a fourth grade education; I'm a politician. So don't play with that.

*When we turn it in, are we going to be redistributing it that day and returning it...*

Yeah, we're going to try and roll it out [in the] same class period. I'm going to talk to my GSIs about how to do that. It could end up being like kind of one of these musical chair circuses where we throw them all up in the air and people grab whatever's in front of them, but I have no idea. I'm still thinking about it in terms of trying to randomize the redistribution.

And then there's this other thing. Where someone sent me this email and said, "Okay. What I'm going to do is I'm going to exchange all my numbers with my friends, and then we're all going to give each other top grades."

And I was like...you know there's a simpler way to cheat than that. Wait until you see what you got, and then tell your friends...ooh, Facebook. You have this stuff...and the thing is...the cheating is dumb. And it's dumb because it doesn't serve you as a grader. Because when you grade, and you gave this guy a top grade, and we look at...

Say that your friend sucks, for example, and they get a 5, 5 and you give them a 9...you're going to get nailed on your grading for not using critical reasoning. I will be very happy to do that. And actually, I have a zero tolerance on cheating.

So...given that you guys actually care about doing a good job, and the cheating is a waste of time because of Karma and learning, and that's why we're all here, then what I suggest you do is you take full advantage of this opportunity as a grader to really exercise some critical reasoning.

You will learn more grading these other papers than you probably will learn from writing them. And, as far as I'm concerned, I've been teaching this class from the get-go as a learning situation. Not as, you know, swallow it and spit it up on the test. Because if you walk out of the class, and you don't learn anything, then I failed. And I want you guys to learn.

And by the way, this was inflicted on me in the high school. We had a class...and you guys are getting off easy. We would present our essay, and someone would stand up and critique it in front of the class, and the rest of the class would critique it for the rest of the hour...tears were shed. It was brutal. But it really taught me a lot about getting to the point. Because if you know that someone is going to rip your stuff apart, then you better cover your ass in a million different ways in terms of the being good in the writing.

It's not be some lazy professor or tired GSI that's going to be grading your stuff by...I throw it off the stairs, and the top step gets an A, and the bottom step gets an F, okay?

It's going to be people that are reading your stuff, and they're looking for holes in your logic and your reasoning, okay? And this is what you're learning in economics. You're learning analytical techniques. So you need...yeah?

*So is the peer grading (grading on your part) pretty much binary? Like you do a good job...*

Zero, five? No. It's going to be zero to five. There will be steps in between.

*Are you going to get the gradings of our briefings back?*

Yeah. That's my goal. So in a sense...we'll distribute the grading of the briefing back, whatever, a week later, and the grading of the second briefing back at the final.

*Can we appeal the grading?*

You can appeal everything, right? Within one week, in writing. And it'll be 15 pages long by the time this get's done right?

Any other questions on this? I think I've said a lot of stuff. Who is still, well I don't even know. I don't even know how to ask it. If you're still dissatisfied, I'm sorry, okay?

We're doing this as an experiment; hopefully you learn something from it. Oh, and by the way. This is called double blind. Neither the reviewer, nor the writer, knows who each other are. It's the double blind...that's the technology.

The next one we're going to do is going to be double blind, but it's really only going to be single blind, because it will be you handing in your briefings, and I'm going to...oh sorry. Your rewritten blogposts as briefing two. And technically...well, I think it should be fine for people who are reviewing your briefing two's to look up at your original blogposts, and then check that against what you handed in, potentially...comments people made. Because I think the first thing that we mentioned that they should do is look and see what the critical values or comments were, and if you addressed them in briefing two.

That will be single blind. You will be grading somebody's briefing two, and they won't know who you are. And the reason that blind grading is popular is because...then you don't have to worry about how popular you are...as far as feedback on people.

Any other questions on this stuff?

*So then the last four digits of our ID are in lieu of our name.*

That's right, yeah. The last four digits in lieu of your name.

I've checked...there are no overlaps in four digit codes.

As usual...but if somebody has some further comment or worry or concern, send me an e-mail on the side (it can be anonymous) and I will deal with it in whatever way I think best.

So there was a thing that I left out from the first half of the class.

Did I give you this example? Market A and Market B? Did I show you this? And there was two different demand curves and all that stuff? So actually, I'm just senile. So we don't have to talk about that. Next.

Baptists and bootleggers. This is relevant for the briefings. There's a tag on my blog, and I think it was a blogpost, but I'm going to tell you about it now so you know what it means.

This was coined by a guy named Bruce Yandle, who's a very charming good ole boy who worked inside the Reagan administration in regulations. He's the one...I was talking to him a couple years ago, and I said, "Bruce, what is up with all the subsidies?" Why don't people fight subsidies in Washington? And he said, "You know, the thing about subsidies is that everybody hates subsidies except for the one that goes to them."

An in a sense, that's where this word "log-rolling" has come about. Have you heard of this world? Log-rolling is essentially the trading of favors. And I actually...I'm trying to think of the image.

And I think of a lumberjack that's running on a log and spinning a log in the water. Have you ever seen one of those things? And that sounds like log rolling to me, but it's kind of like...I scratch your back, you scratch mine, and what happens is when you have any kind of political compromise, you've got Mr. A, Mr. B, Mr. C, and Mr. D.

And D wants this, and B wants that. And C wants this, and A wants that.

And then they're all like...I'll vote for your thing if you vote for my thing. Right? That's trading of favors.

Log rolling—that's the expression in politics. And that's how a lot of negotiations get done, and compromises are made. Sometimes the bad news is that all of those people get what they want at the expense of Mr. E. So that's sometimes why it's critical to have a seat at the table or to have veto power, for example.

Governor Schwarzenegger, in the waterfront, has basically said...I'm pretty sure he's backed off. But he said, "I will not do anything in terms of reforming California water law unless there are dams included."

Almost any economist knows that any new dams in California are a complete waste of money. But Governor Schwarzenegger, according to somebody that I was talking to, has got religion (meaning completely irrational desire for dams), and he will not...sorry about that, religious people, but religion actually is not about rationality as far as I'm concerned. It's a belief, because it's...the difference between religion and rationality.

So he believes the dams are necessary regardless of all of the evidence, right? And for him (a person who has veto power), he's basically saying...a couple weeks he was saying...I'm going to veto 700 bills unless you give me dams in the water bill. And then he backed away because I think he realized how stupid he looked.

And now the new water bill that's under negotiation that I'm following from a very great distance...I'm not sure, but I think it has no dams in it.

And that, in a sense, showing how outside the perspective was. He can't bring that to the table as a negotiating position because it's just non-tenuous. There's just not enough support on these other groups to keep that dam item on the agenda.

So that's what log rolling refers to.

Baptists and bootleggers is a much more insidious concept that is significant in terms of the propaganda of politics.

And the analogy is a very simple one. Imagine that you're in a southern town where the Baptists are the prevalent congregation. The Baptists tend to be very conservative in their beliefs, and one of they're believes is that you should not be drinking alcohol.

Now this is not exactly a dry town, and what they do is they go to the city council and they say, "It's God's will that we not sell alcohol on Sunday." Because it's the Lord's day for the Lord's business. We shouldn't be selling it. We can't keep people from buying it, because they buy it on a different day, but let's not sell it. And the city council, in order to keep their political approval ratings among the majority population of the town says, "That's a good idea."

We will ban the sale of alcohol on Sunday. And the Baptists, who are the "Holier than thou" type...

These are the angels. The angels do something that's good for us.

But then, what happens to the supply and the demand for alcohol on Sunday? There's our demand, and there's our supply.

What happens to the supply of alcohol on a Sunday?

*Would there be no supply?*

Would there be no supply?

I'll tell you. If you want to buy this for \$2000, I'll sell it to you right now.

*Blackmarket.*

Blackmarket.

*People who bought alcohol on Saturday.*

There is going to be a resale market, right? But let's just say it this way. There's going to be a shift in on the Supply curve. That's pretty obvious...because you just eliminated the retail competition.

And the people that are still selling alcohol on Sunday are the bootleggers. Bootleggers (a term from the prohibition) are the people that don't follow the retail licensing laws.

They will sell you alcohol out of their boot, or (literally out of their boot) out of their trunk (which is a boot in English terminology, right?)

So you can still get alcohol; and guess what happens to the price? It goes up, and all the boozers have got to pay more.

*Can't you go to another city?*

We're just going to make it a Baptist region. Transaction costs are huge, right? But that's a great example.

I know that you have dry counties in various states, and you just go to the next county over. Alcohol laws are insane. They're really amazing.

*Actually, about that, I think that in Alaska there are a lot of dry...and basically a bottle of whiskey that you can buy at the store for \$10 sells at one of those for \$250. And all it does is it creates a huge incentive for people to try and get the alcohol.*

Yeah...I mean...banning alcohol sales...guess what...black market. Prohibition. Banning drug sales—black market. Drug dealers. It just happens over and over again. Go to Scandinavia where beer costs \$10. People are like getting off the plane, going to the duty free, buying cases of beer and bottles of vodka, and taking it home.

It just channels that demand somewhere else. Now I think there is a shift in (in terms of quantity consumed). But what's going on with consumer surplus if we actually care? Consumer surplus is lower. And, more importantly, there's a transfer of rents to those bootleggers. So what happens is...when city council says...oh my god we have to do the lord's work and save our citizens, the bootleggers are like, "Oh boy, can't wait for that one."

Now, this example of Baptists and bootleggers happens a lot. And it doesn't happen just for alcohol. Another example that Bruce gave that was very good is lawn mower manufacturing and safety regulations. The lawn mower has to have an automatic stop. It has to have a blade...if you get your finger near it, it stops; there's all kinds of things you could say in the name of safety, right? To the point where the safety features are like rocket science. Your lawn mower is more advanced than the car parked in your driveway.

Who benefits from that kind of regulation?

*Whoever makes all the safety components?*

Whoever makes all the safety components, yes, and which manufacturers benefit? And which manufacturers lose?

*The low cost manufacturers lose because they probably don't have the ability, the technology, to put all that in...*

The guys that are just selling...I mean...

Imagine one of those manual mowers that don't have any guards at all.

You just walk along, and...oh my god a baby could fall in there and die! So we're going to have to cover the mower and put a warning sign and automatic bumpers and stuff like that.

The company that has been making the same mower for 150 years is out of business.

So the low cost competitors lose, and what happens to the consumers? How do they do?

Are they better off or worse off? Are they safer? Maybe. Sometimes they're safer from nothing. You could have a regulation that will keep you safe from nothing, but it's a regulation. It's the whole...putting baby seats on an airplane type of thing.

Now that I think about it, I think that the baby seats on the airplane is just a stupid example of something that never happened.

It sounds too dumb to be true. I'll have to look that up.

*For our briefing, we have to avoid that situation where you would please both groups.*

Well...hat you're trying to do, you're trying to maximize benefits to society, and you're trying to go against this special interest combination. This is a typical combination that special interests come up with. So if you can use that same Baptists and bootleggers logic to get what you want in terms of benefitting the public, then go for it.

But usually this implies some special interest groups. Does that answer your question? No?

*I'm just confused what you mean by like...benefit the average, but not the special interest group? So you wouldn't benefit the bootleggers or the Baptists, but rather...*

This...the benefits to the Baptists are zero, because they don't drink booze. The benefits to the bootleggers are large, and positive, but there's a...the social welfare in terms of the whole deadweight loss triangle...the one we're always used to talking about...is smaller.

There is a transfer of rents from consumers to producers, first of all. There's a deadweight loss secondly, right? So I want you, in your briefing, to talk...to think from the prospective of consumers.

*Wouldn't there be a nonmonetary event for the Baptists where...*

Meaning they feel better about other people not drinking? I think yes, but that falls under the category that I'm not going to condone. If I feel good because that person's dead, it's not exactly the kind of logic I want to pursue. Because that's what it is. I feel good when you feel bad. So if somebody wants to drink, that's fine. If it's drunk driving killing innocent children, then that's a different story.

I read this thing about the founders of MADD (mothers against drunk driving). And she was pissed off because she said, "I founded this organization because my daughter was killed by a drunk driver."

And the people that...she actually denounces her own organization. Because they took over, and they wanted it to become prohibitionist. She's like...I like drinking. I just don't like drinking and driving.

So if you're focusing on drinking and driving, don't go over drinking. Think about the outcome. Fight the outcome. Don't fight the process that might not lead to it. Kind of like treat the symptoms, not the disease, or the other way a round. I don't know. It was a bad analogy. Yeah?

*So with the alcohol example, I'm just curious to know...what about...what would you...because it's the same problem...we're just saying they're not going to pay...*

I think that the funniest thing is that the drug dealers, especially the cartels that are having this kind of civil war in Mexico right now, they don't want those drugs to be legal. They're making crazy profits.

I did some research on opium and heroin, and heroin...at the Afghan, Pakistani border, where a lot of opium and heroin comes from, it sells for about \$1000 a kilo of heroin (100% pure). It sells for \$850,000 a kilo in the United States. That's a price markup, right? Drug dealers make

so much money, that they will fly a plane over the border, take the drugs out of the plane, and leave the plane behind, because that's worth less.

So the economics of drugs is insane because of the profitability of those drugs. That's why they also kill each other all the time.

*So would you suggest to legalize all drugs? I would think that some people would...*

I do, yeah.

*So even heroin and...*

Legalize and regulate. Like cigarettes, and alcohol, and pharma drugs. In fact, most of the pharma drugs suck compared to the legal drugs. When I got my surgery, they gave me this opiate, and I was like psh...I've got better than that.

The funny thing is in Holland, they have medical marijuana, but no one buys it, because they get better Marijuana in coffee shops.

*That brings up my next point is...Holland, where it is legal...they actually...at least I heard that there's...Where the other drug use is higher too because they have a lot of problems with heroin and cocaine.*

That's the gateway drug hypothesis. So the gateway drug hypothesis, which is a little bit of a diversion, but it's one of my favorite topics, so I will indulge you.

So the gateway drug hypothesis is that...oh you use heroin, you use marijuana, so marijuana leads to heroin. And other people who are clever with their analysis have said that breast milk is also a gateway drug. Because people that use heroin also drank breast milk. So clearly breast milk is a gateway drug.

That was a joke if you guys didn't get it.

So the statistics on the marijuana use in Holland is that there's lower population participation in marijuana in Holland than in this country...something like 17%.

My girlfriend is Dutch. And she's like, "You're stupid you smoke dope." I'm like...whatever, I'm an American.

They all go through it like the French go through drinking wine. You're drinking wine when you're 13, and by the time you're 21, you're boring. What's up with all these drunk people? Because the English people show up and they get drunk right? Or they do drugs. And the Dutch and French are like "Weird". Because they never acclimatized to using the drug.

So that's the complicated thing. The gateway drug...there's a counterexample to the gateway drug hypothesis which is that if you make marijuana illegal and you have to go to a dealer to buy it, and the dealer's like, "hey, I've got marijuana, cocaine, heroin, ecstasy...all these other things."

And you're like good, I'm already at the mall, why don't I get everything? So making it illegal leads to more drug use. It's complicated. But the one thing is that the statistics on marijuana are

incontrovertible. They are...that lower marijuana use when it's legalized in that country. And there are obviously...its almost de facto legal in California. Anybody can get a medical card in 20 minutes. And a \$100.

Anybody else questions?

*So there was one that was like prostitution...that was one of the examples? So people who want to limit the number of prostitutions...*

Make prostitution illegal, and only pimps can stay in business. Absolutely right. Because the pimps are a very interesting category too. Another one of my favorite topics. I have a friend that I would never recommend...never introduce to a girl who I knew, because he's one of these... you have these kinds of dodgy guy friends who you just don't want your girlfriends to meet... and he's like, "Thank god for abusive fathers, otherwise we wouldn't have prostitutes and strippers."

So there's this really sad thing going down with that, and the psychology of prostitution and pimps is actually very sad. It's very perverse.

I was talking to a student group the other day about going to Amsterdam. And, you know, prostitution is legal there.

And I went to the prostitution information center. And it's like so...

And there's these prostitutes just sitting there, and they're like, "What do you want to know about it?" It's like an info booth. It's like...oh you want to get on the Metro, or whatever. And I said, "So what are you guys really worried about?"

And they're like, "Oh we're worried about our pensions."

Because they're just like workers. And it was so bloody boring. And a lot of the prostitutes will say they don't want to deal with pimps because pimps get a piece of the action. In fact, they get...this is actually shocking.

Prostitutes don't make any money at all. They had it all over to their pimps. And the pimps will give them...they'll take care of them. And that's part of the mind-fuck that goes on between prostitutes and pimps.

If they can actually go off and be independent contractors, or band together in a cooperative, and stuff like that...because it is legal, then it's better for them. The prostitutes, right? And I'm not even talking about female trafficking and stuff like that, which...female trafficking is a disaster.

Las Vegas has a lot of trafficked women. I was surprised...not too surprised to hear that. Prostitution is illegal in Las Vegas, if you didn't know that.

*I thought it was legal there?*

It's legal in the counties in Nevada that have a population of less than whatever.

Clark County has a population of more than whatever. So it's legal to go...it's like [inaudible] said, "It's legal to fuck, it's legal to buy things, why isn't it legal to..." Whatever, right?

That's another kind of Baptist and Bootlegger thing. It's like ooh, Las Vegas! We don't have prostitution here. Let's ban it. We'll save ourselves from it.

And all the pimps are like, "Yah". Because all the convention guys...they don't want to go out in the desert, right? But they come in and a lot of the girls are trafficked. I was told that it's one of the worst trafficking locations in the world. And that's sad.

*But in social welfare, for example it would be like the prostitute?*

Absolutely. If you did a Baptist and Bootleggers on prostitution, the people that are hurt by illegal prostitution are the prostitutes. They lose money to pimps. The pimps inflict violence on them. Their johns can inflict violence on them.

They get a lower price because they can't offer to a competitive market. They kind of like...how much for this, how much for that?

The johns clearly lose welfare because they have a harder search mechanism. The pimps make a lot of money. And the cops...they make...lot's of bad things. Cops getting free sex off of prostitutes is a huge problem. It's just like rape.

*I think in this example, we're kind of assuming that prostitutes want to be prostitutes...*

Totally assuming that, yes.

*So what about the fact that a lot of prostitutes are not actually willing...or they don't actually want this career.*

That's...trafficking basically...the girls that are trafficked are enslaved. Any other words that you want to use. Those prostitutes are worse off in an illegal environment because everybody is illegal. And, even worse, if you're trafficked, and it's illegal, and you come from another country, and they've got your passport...you're already breaking the law once, because you're an illegal migrant, and you're breaking the law twice because you're a prostitute. So you're afraid to go to the police because you're actually doing something that's illegal, right? This is also the problem with migrant workers.

Who benefits from illegal migrant workers? Do the workers benefit from that? Kind of, because the workers crossed the border, or most of them. But the people who really benefit from that are the coyotes and the people that run the labor gangs.

He basically says...Professor Martin up at Davis...he basically says that the worst labor crew leaders are also Mexican nationals because they know how to push these workers within an inch of their life, which is bad for the workers.

Who else benefits? The farmers who want to pay below market wages. We are harmed as a taxpaying population because medical claims and school claims by people that are not paying into the tax system and are only going to emergency when they are losing blood because they can't go for competitive medicine.

So the Baptist/bootleggers thing occurs over and over again. And people are like, "Oh!" This is the problem. It's like...we have to save such and such a population or stop such and such a bad

behavior by making it illegal. That...you've got to remember...making it illegal doesn't mean that people will stop doing it, right?

I'm not saying murder should be made legal because it's clearly a problem. But the alignment between cost and benefit between murderer and murder victim are much clearer.

But the Baptists and bootleggers involve these triangles of different groups. Does that answer this question? I think that involuntary prostitution is a disaster. Actually I am a big fan of shooting people who do that.

*I don't really mean...a reinforcement of prostitution, but I mean like...economic incentives.*

Ah. Economic incentives. Well in that sense you would be in favor of legal prostitution because then the girls would make more money, and they'd get out of it sooner. There's many of them...

It's like: "Yeah, I bought my house and..."

And I actually just saw a paper that just came out and...if somebody's curious about it, send me an e-mail. It's like 60 pages. With serious amounts of data.

And prostitutes that are being surveyed through one of these prostitute rating websites...it's like Yelp for prostitutes. And they're making \$250 dollars an hour as escorts. And so...taking that into consideration, I hope that it's a risk/reward relationship that they're interested in. But then there's an entire economics of prostitution, which is quite interesting in many ways.

*But don't Baptist/bootlegger issues involve property right issues, so we couldn't use them in our paper...*

You can use them in your paper. It doesn't necessarily involve property rights.

*I mean...making prostitution legal is property...does that not mean...*

No it's not...that's going from...remember the diagram that I said in the start of the semester...

Markets, missing markets. We're talking about missing markets. We're talking about a missing market. Because the market has been turned black.

*Well you mean missing market...we can identify a missing market...it's pretty...*

Well what's going on with the whole Baptists/bootlegger thing is that they're taking a market and making it missing in order to turn it into a blackmarket, in a way. I mean...missing markets are more of environmental goods and stuff like that, but going from a market to a black market is kind of like adding massive transaction costs and making it inefficient. So we're talking really about changing the dynamics of an existing market. I think that that's wrong. It's not missing. It's changing the dynamics of an existing market, and increasing transactions costs.

Changing market power, that's what's really going on as far as drugs and prostitutions and stuff like that.

What you guys might be concerned about in your briefing are missing markets, maybe, because maybe all of us should be benefiting from environmental regulation for legislation to stop the

world from warming up. But there's a lobby from the energy companies that are allowed to sell energy. I mean...their business is selling carbon. Shut down my business—I lose money. So they have an incentive to block legislation that reduces the use of carbon. Any other questions on the Baptist/bootlegger stuff? I'll get to principle agent.

*So you're trying change the behavior of consumers by changing...*

I am not trying to change the behavior.

*But it seems like the products...or whatever the issue is...they're inelastic...*

Right. That's a good question.

Are we changing the demand of consumers? When I wrote this up, I just had the demand function sitting here. There's clearly a shift in for demand when you make something illegal because some consumers do not have the taste of consuming illegal goods. And on the other hand, some of them do. Teenagers and smoking. Oh it's illegal! Can't wait to do it.

It's dubious how that's shifting demand. I'm just taking that as given, and I'm saying...we're talking about supply shifts.

Because when you eliminate all the retailers, your shifting...affecting the supply, right? And just looking at that and holding demand constant, you can make an analysis.

*So for our briefings, are we supposed to be appealing to the Baptists?*

I said you can...the Baptist/bootlegger dynamic would tend to be going against what you're writing in favor of

*Doesn't everyone want to be like the good guy? [Yeah] like I want to fight this bad thing...if a politician does something against that then...They should be appealing to me.*

You can use this mechanism. You can use this technique to advance your cause but remember that your cause is this. You're trying to max this. So if you shift it in, you're going the wrong direction. But the people that you're fighting against will be trying to shift in. They will be trying to cut supply so they can benefit from it.

As the example...Baptists and bootleggers, right? The businesses are...

Actually it's the same kind of shift. If you have carbon legislation, then you might be shifting in, but you're increasing costs essentially through a tax or whatever. So those people might be upset about selling less carbon. So it's the same shift in that the special interest will be fighting against. But then there's also the distribution inside of this pie.

It is very, very common in politics. And that's also...you can address these issues...any combination of issues. But your whole goal really is how do I do something that's going to have a net benefit on social welfare despite the interests of a special interest group?

*I have a question...I'm not sure if it's a Baptists and Bootleggers example, but like...if you have a situation where it's like an environmental legislation, like a section of the forest is preserved due to the environmental concerns, but that eliminates...like a person introduces a population*

*living there that needed that forest...but in a way it's like bootlegging because you have got the government or the police involved...then it's like...you create some form of corruption and bribery to let people use the forest or not eat the forest...I don't know if it's directly a Baptist and Bootleggers...*

That's a good example, and I think that fits in with the Baptists and Bootleggers example. What happens is (this is a very common problem). You're going to have a beautiful nature area, and you're going to have...and there's going to be an indigenous population living in there. And they're going to make a national park out of it. And they follow the US national park model, which is that no people are allowed inside, and it has to be pristine without people. So people all move outside, and in the worse case scenario, they are hunter-gatherers, then they have no source of income anymore, right? They've essentially...they have no property rights. It's been taken away by the government. And then...many things can happen. One is that they just are poorer and suffer. And another one is that they go in, and they are now illegally doing what they used to do.

But because it's not their property anymore, they don't care about being sustainable. So they will poach animals, or they will overharvest trees, or whatever. But the typical situation that's even worse...is that the army (or whoever's guarding it) will also really get into poaching, or really getting into cutting down trees.

I know this is a huge problem in Nepal. Part of the civil war in Nepal was being fought over access to the forest and stuff like that.

Also happens in Africa a lot with all of their national parks. We've got to keep it for the Zungus. Muzungus? The Swahili word for white people is Muzungus, I think. Anyway. All the white people are going to come in and pay \$50 to go to such and such a safari, and all the locals are kicked out, and their going to be like...much poorer. And all the muzungus...but the local people are not benefiting. All the proceeds go to the central government. The central government is corrupt, and you know it's this horrible cycle. So that happens a lot in natural resources especially.

It will happen with fisheries. The government of the West African countries will sell the right to fish in the EU which has already fished all of their seas. And they'll come in and exploit the West African fisheries. All the fishermen—out of work. But instead of going out three kilometers to fish, they have to go out 50. So they're spending all this fuel going back and forth, and they can't even eat.

And all their fish are going on a fish processing ship to go to fish and chips. And the governments are taking the money for their permits, and not giving it to the people (which is their natural wealth) because they're buying corporate jets and Swiss bank accounts.

It's just horrible, it drives me crazy.

*So let's say that this is our issue for the briefing, the politician will essentially try helping the indigenous? That's what our goal would be?*

In a sense, yes. What you would want to do is you would want to do...if it's a status quo situation, then you might want to maintain it against the special group that wants to log the

forest, for example. Or, you might want to say...how can we monetize this forest? This is a very big topic in carbon (in the climate change, right?) how can we monetize the forest? And you might say, "Well...why don't we give all of these guys property rights so they can collect the money from the forest not getting cut down? But then you're going to be fighting against the constituency that's going to want to eliminate those owners and turn it into a managed reserved that's going to get clear-cut. And there'll be fraudulent certificates that are sold, and all kinds of crap. I mean, in a sense, there's unlimited material in the news right now about how almost every kind of...a lot of these failures are coming back to this, essentially, special interest dynamic.

*But aren't the Native Americans a special interest group. Why aren't they a special interest group?*

Well they were, but they got destroyed in many different ways.

*But let's just say we take this situation where they're living in the National Park, and there's a company trying to log it, or you try to block off the area or keep it for them without destroying the national park. So you're benefiting the native American at the expense of the logging company, at the expense of the consumer, who would have cheaper goods if the logging company increased the supply after logging.*

Who owns the national park?

*It's government property.*

Why are the natives living on government property.

*Well, I mean...everything is government property. I'm living on government property.*

Ah. Okay. Start over; we're back to ground zero where the government controls everything, and there's some special interest group called Native Americans who want to live there (what you're saying)

*Right.*

So we have to fight against this special interest group.

*What I'm saying is how do we act in this situation without benefiting some special interest group? Everyone's a special interest group.*

Ah. How do you...yeah...broadly defined.

*My questions was more like...could you give me a definition of special interest group so I have a better idea of what I'm...*

Here's a good question. Let's look at the dynamic of this for a second. Let's look at what's going on. We won't use this. Let's say that...this is the sum total of social welfare just now... under status quo conditions.

Now let's say that...you can go one of two ways. You could either go over here as a policy that destroys overall welfare but distributes a lot of it to special interest groups. In a sense like...oh,

let's clear-cut the forest. The clear-cut forest is worth a lot less than the alternative policy, which is to monetize that forest.

And a special interest piece of that pie (let's make it smaller)

The special interests are getting a small piece of a much larger pie. And this is us.

So its okay to benefit a special interest group as long as society benefits more than the special interest groups.

In a sense, it's okay to benefit a special interest group as long as overall benefits are greater. So what you want is you want to get to this kind of...

So we're not going to shoot all our special interest groups because that's kind of like shooting ourselves, right? Everybody's a special interest in some way. People are out there lobbying for school fees—special interest group.

So what we want is we want the pie to get bigger, period. And we want the share of wealth that goes to us (we the people). We want that share of wealth to be greater. So maximize social welfare, and maximize distribution to the general public.

Special interest groups will always be around. They might be...but the thing is the special groups will clearly fight against this because why? Why would special interests fight against this?

*They're not getting much out of the...*

That's right. They're getting more goodies out of this one. They don't give a shift about everybody else. That's the whole US Sugar Policy is to do exactly like that. We pay double or triple the world price for sugar. And it helps those little special interests, and it harms all of us to the tune of only \$1 a year.

But a dollar per American is \$300 million going to the thousands of people living in Florida and Louisiana. And destroy the bijou, by the way.

*Going back to the readings, Olson's reading? Olson's talking about the first smaller pie. And Ostrom is talking about the bigger...is that...*

Lynn Ostrom is talking about how do we get to this kinds of situations through dealing with those collective action types of dynamics. If you want, Mancur Olson is kind of like of the pessimist. Like oh my god, everything's going to fall into a disaster. And he's been proven right a million times, right?

But Lynn Ostrom is kind of like the optimist. It's like...well look...we don't have to go that way, right? If you know Lynn Ostrom, you think...the only thing you can do is privatize everything. But she's like into community management. But I mentioned in the briefing explicitly. You cannot wait for the community to involve. Because some of Lynn Ostrom's prescriptions...not prescriptions...the stuff that she studies takes years to evolve, right? You're talking about an election cycle. You can't wake up and care about everybody. And you can't evolve a whole bunch of social norms or new religions or whatever.

*So back to this example, wouldn't it be a larger benefit for like the public, perhaps, to use the forest for production and...*

It might.

*Because it could benefit consumers, and so then they pay less than the price for...*

Unless all the wood gets sent to Japan. The world. It could. The value of the standing forest these days tends to be higher than the cut forest. We haven't done a lot of dynamics of natural resources, but the future tends to matter.

*I feel like...even though it would give more benefit to consumers and what not in the short run, I think the long run the costs are a lot greater. And especially with like the environment more than anything is like a capped resource. You can't go past a certain amount. Because then all the forests would...*

That's fine. Take the long run into consideration. I want you to consider long term social welfare, which is longer than an election cycle. Otherwise we'd chop everything down every two years, right?

*This is more of a general question for special interest groups...so is the general theory that special interest groups are interested in getting the bigger share in absolute terms, or are they interested in getting a bigger share than anybody else because...I guess that's not so rational. That's not...some people might prefer to have \$80 and everybody else have \$60, rather than everybody having \$100.*

Right. Those are two different dynamics. The one that we're talking about is having an absolutely bigger share. This is this one here.

But when you look at people and their psychology of positioning themselves, it's fairly well established that when you give people a choice between this and this, they will prefer this. It's troublesome but it's human.

*Which for the special interest group, in that case, would still prefer the smaller circle where they get  $\frac{3}{4}$ , even though they have...*

Right. So both of those dynamics are in concert in that situation. And that's okay. you can use those turbo powered incentives if you want to.

*Okay so my question is with the "and still get elected" part. So are you assuming that, by benefiting the average citizen, which is a bigger population than the special interest groups, that you will get reelected because you're benefiting them, or that you're just going to pick those special interests groups off, and there's all this corruption going on, and they won't be real...*

When I talk about elections, you have to consider the dynamics of reelection, which are essentially driven by money.

So if you do something that benefits every American to the tune (say you're running for President, or whatever.) Every American is benefitting to the tune of \$5.

And then the logic of collective action...

And then there's a special interest group, and they're getting five million dollars per person. And you think about the problem with election, which is essentially fundraising, and getting everybody to even notice that they're \$5 better off. Let alone donate that money to you.

Hey, let's just share it, give me one dollar. So then there's a problem of...which Olson discusses...which is...in the special interest groups...not only do they get more money, but they can coordinate to move that money...that wall of money.

It might be smaller in total (in fact, by definition, it's almost smaller in total). So they might have...say that all Americans have 300 million in benefits, and the special interests have 20 million in benefits. And they can kick in 10 to the politicians (to the opposition right?).

And the other...all the Americans kick in only 5, then this politician will beat this politician here.

*And that's our politician.*

Unfortunately, right? So you got to get this guy reelected. And this is a very, very common dynamic as well.

*Basically you get them...you give them more money.*

And that's what you come up with. How do I get them more money? How do I get them reelected?

They can get reelected through any means except for like...declaring dictatorship. Does that answer your question? This is a very common problem in politics. Even if elections are not fixed, which are a different problem.

*It seems like a lot of the dynamics of reelections depends a lot on special interest groups, so... but...in this problem, we're supposed to not benefit special interest groups.*

This is Berkeley; we're going to change the world. Think big, think pictures.

*With the policy, what if I know I'm going to be benefiting them in the long run. Like one unit...in ten years the all pay auction will be different. But will I still get reelected with that?*

If they read you're briefing and do what you say, they will get reelected. That's your job.

*To convince the public that it's worth it now?*

Right. And you can use any legal maneuver as far as I'm concerned. Any rhetorical maneuver. Doing the right thing is not really a rhetorical maneuver, but you can try it.

I'm going to move along for a minute and keep going on principle agent stuff, which is all related to the same topic.

I just wanted to discuss microfinance. So microfinance: who's heard of that concept before? Who's heard of Mohammed Yunus? Winner of the peace prize? Deserving winner of the peace prize? Maybe Obama should win it in 10 years. But anyway...

Yunus is a guy from Bangladesh who ironically was an economist who won the peace price. And his whole idea was called microfinance. And it just means small. And basically what he thought of a long time ago was like is...wow look at all of these small entrepreneurs. I bet they could use a loan to increase their business. Because they...their capital is starved. Another person who's big on the whole starvation thing is a guy named Hernando de Soto from Peru. And Yunus said...if I've got a lady who's got a kiosk who's selling biscuits and cooking oil, if I give her \$20, she can potentially double up her inventory and double her profits, and pay back the \$20. So I will finance her with a little microfinance. I'll give her \$20.

So the problem with a loan like that is that you create (essentially) a principle agent relationship. You've got the borrower, and the borrower is going to have 2 issues as far as the lender is concerned. What are those two issues? Jargon?

Moral hazard. What's the other one?

Adverse selection, right? So we have problems with adverse selection and moral hazard.

And when you're giving somebody a \$20 loan, do you have time to go and talk to that people's people and figure out if they're a good businessperson? do you have time to monitor them and make sure they're booking all their profits appropriately? Yes or no?

No.

No.

The transactions cost of making that loan is too high. You might be making \$2, and in order to do a proper evaluation and monitoring, it might cost you \$20. You don't even make any money to lose your capital. So the Grameen bank, which is the bank that Yunus started, figured out how to solve that problem. Does anybody know?

*He loans in groups of five, so when they're organizing in a group they're accountable to each other*

A group. Yes, go ahead.

*So that they're accountable to each other. Because it's like you have community values where you have a tiny community where the women don't want to...because it's like if one person doesn't pay...the rest of the group...*

So let's stop there and go over what happens.

So what Grameen bank did, is they (and I'm not sure if they were the first, but they are the most famous for this) is they do what's called group lending. And it turns out that this idea is a very old idea. There's this...in some cultures what happens is you'll get ten of your friends together, and every month everybody puts in \$10. And every 10 months, you get the \$120. It's kind of a forced saving scheme. So you're essentially getting liquidity (each person) by turns. Because it turns out that \$10 a month is not nearly as handy as having \$120 all at once.

Group lending works in a slightly different way. You get 5 people that are jointly liable for the loan. And the key is that these five people are self-selected. So if you want a loan for the

Grameen bank, you say...I'm here with four of my friends. All of us are going to apply for this loan. And all of us are going to guarantee repayment of this loan.

And we know that if we do not repay this loan, we know that we will not get another loan (ever) from this bank. So what happens when you have...what happens as far as adverse selection is concerned?

How does this fix adverse selection? Think about if you, yourself, were in this situation. Who would you go to the bank with if you were getting a loan? The people you trust the most. Are you going to go with your deadbeat friend who forgot to pay you back 4 weeks in a row for the bar tab? No. They're still your friend, but they're not going to get a loan with you.

So this fixes the problem of adverse selection. And then what happens in terms of repaying that loan?

*Your friends will pressure you to pay back the loan?*

Your friends will kill you. The loan officer can't kill you, but your friends can. So I'm sure they're going to be like...you know...I'm sure there's like a Facebook app called "pay me back" right?

So they've got moral hazard taken care of because the friends are all monitoring each other. If you've got that little kiosk, and you're taking every other thing of oil home, and all you're friends are like...well it looks like their selling a lot of oil, and you're like, "No, I'm just making a lot of French fries. Boy they're yummy. Thank god you pledged your money on my French fry eating."

Your friends are going to get on your ass. So these are the two key components of group lending. It did not hurt that Yunus...the Grameen bank...emphasized this loan to women.

As is true almost all the time in development economics, trusting women is a much smarter idea than trusting men. Because the men...they get the money...they're like, "Oh! Party! Let's go drinking!" Right?

The women are like...they have to take care of the kids, themselves, and all that kind of stuff. So the big one was the group lending. The secondary benefit is running these loans to groups of women. They don't discriminate based on gender. But they targeted women. And it turns out that phase II...the Grameen bank is actually...

It's not the people who need loans...it turns out they actually need a place to save their money. They need banks.

And in some cultures they need to save the money because if there is money there, it belongs to all of us. It's like way worse communism than what we have in this country, right?

If you go to a typical American family, and it's like...mother and dad are there...it's like, "Oh, you've got \$20. Give me your money." Right? And the kid's like, "No way, that's my money! It's my bank account!" or whatever. But in these other countries that have more communal traditions, where all's share and share alike, it becomes very difficult to save money if your

cousins keep running by and raiding the cash box. Let's stop there. And see you guys on Thursday. Office hours right now.

**Transcribed and checked for accuracy by Brynna Bunnag**