

Clicker quiz: Should the cocaine trade be legalized?

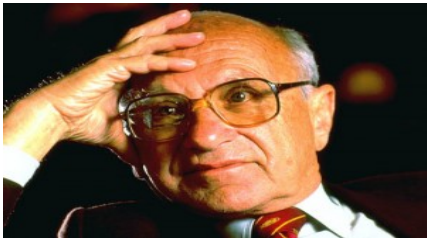
- 1. yes
- 2. no

Review: What is the role of the state:



Fred Hayek

- To ensure competition in the market
- Why?
- It's the **most efficient**
- Ensures the **most freedom**
- If the state doesn't ensure competition, **monopolies** will develop—undermining freedom
- States also protect competition by regulating externalities



Milt
Friedman

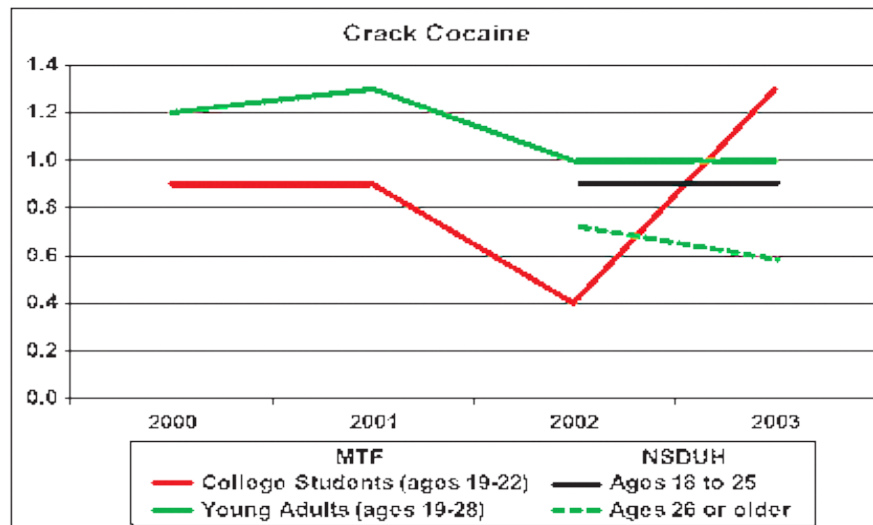
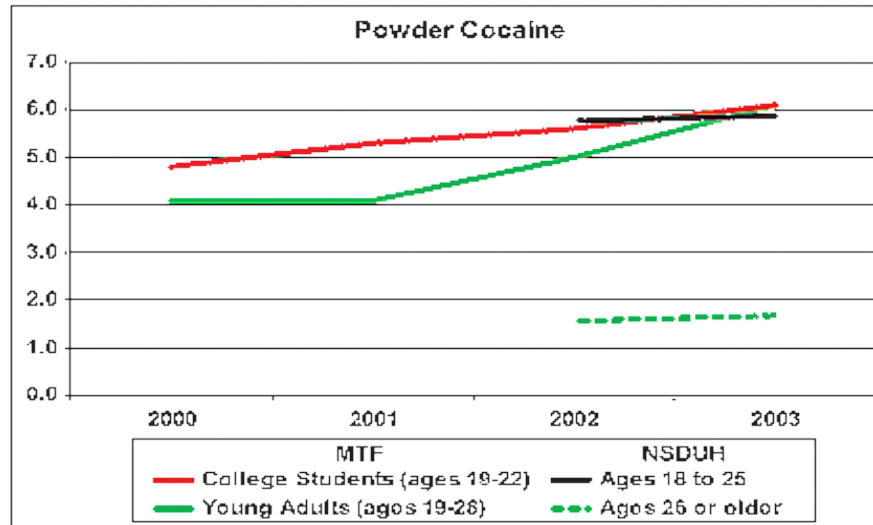
Example: A spontaneous Cocaine market



Coca supply is abundant.....production costs low...
processing is easy and cheap, market is large



Demand is High and steady



Illegality represses demand and supply, raising the price

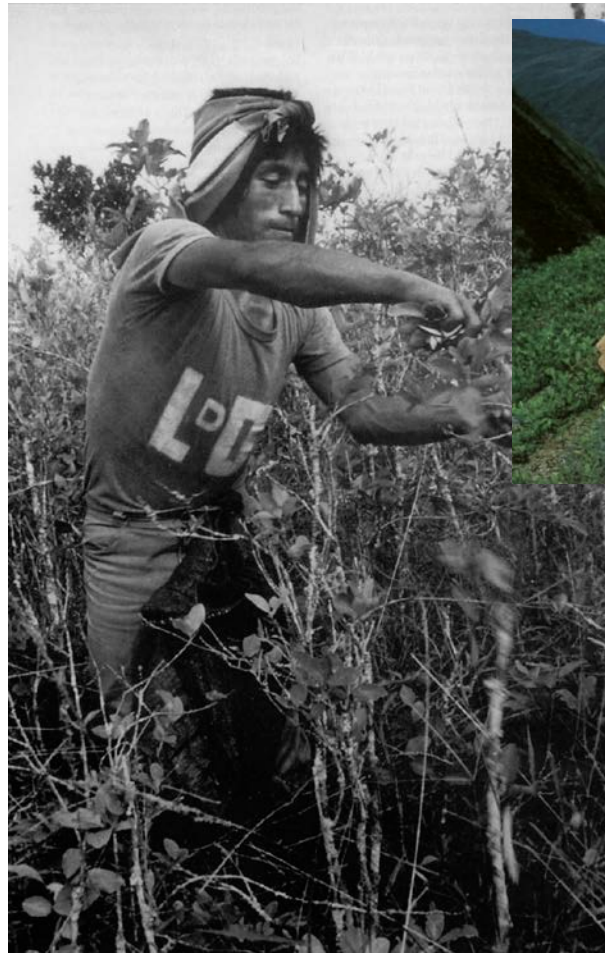


So It's rational to produce coca.....

**Corn: \$150 per
acre**

**Livestock: few \$
per acre**

**Cocoa: \$5-10,000
per acre**



**What crop
would a
rational farmer
grow?**

And rational to sell it.....



Government should foster competition: Illegality and high prices create drug lords with market monopoly.

Monopoly creates.....

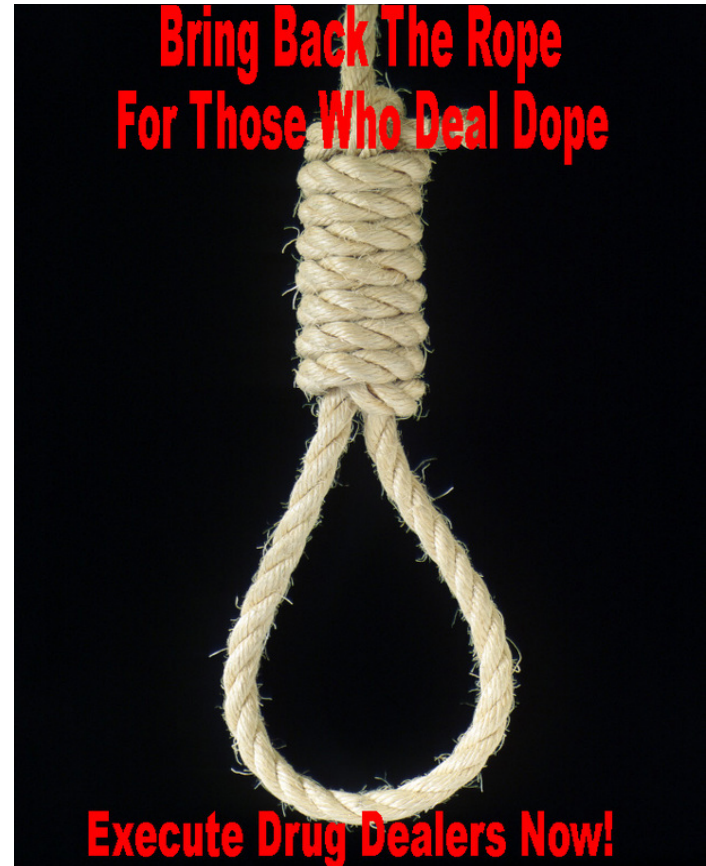
Obscene profits for drug lords

Pomona, CA
1/18/2006

\$1,390,965.00 U.S. Currency



Govt. efforts to make the market illegal means coercion



**The Economic Liberal believes: The
War on Drugs suppresses Freedom...**



Summary:

- People make rational choices
- Rational people create spontaneous markets,
- Thus markets are “natural” and should be free
- Free exchange creates “true” prices
- Thus states should stay out of markets.....
- Their job is to ensure competition, not foster cooperation
- States will never be powerful or wise enough to suppress natural and spontaneous markets

Calculate whether you should join a study group for your classes: What is the most rational way to achieve your education goals?

1. Competition with other students
2. Cooperation with other students

Rational Choice Theory shows that competition is rational

- assumptions
- strategic interaction and prisoners dilemma
- Argue that cooperation is best for all but it's hard to get: the problem of collective action
- Discuss the argument that Institutions and governments are necessary to ensure cooperation---
- Rather than through government, problems of cooperation can be solved through the market mechanism: Coase Theorem

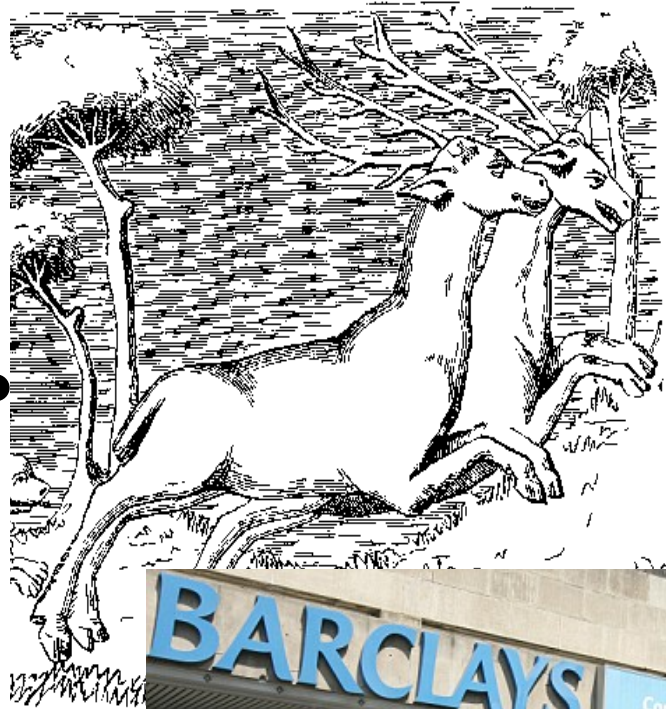
What about the “rationality” assumption?

- the same as in economic liberal theory
 - Individual freedom and equality
 - Self interest
 - rationality
 - shaped by constraints and incentives
 - Costs and benefits
 - the Strategic environment
 - Strategic interaction

Rationality and Game Theory: When individual rationality can be irrational and competition suboptimal

- Why Game Theory?
 - A Game is a Model of reality:
 - Game:
 1. Players
 2. Strategies:
 3. Payoffs:

Game of getting what you want : The Stag Hunt-



Cooperation is optimal but rarely achieved: Here is what the calculations look like:

		ME	
		stag	rabbit
YOU	cooperate stag	5 , 5	0 , 3
	Defect rabbit	3 , 0	3 , 3

That's a second game: the prisoners dilemma



What would you do?

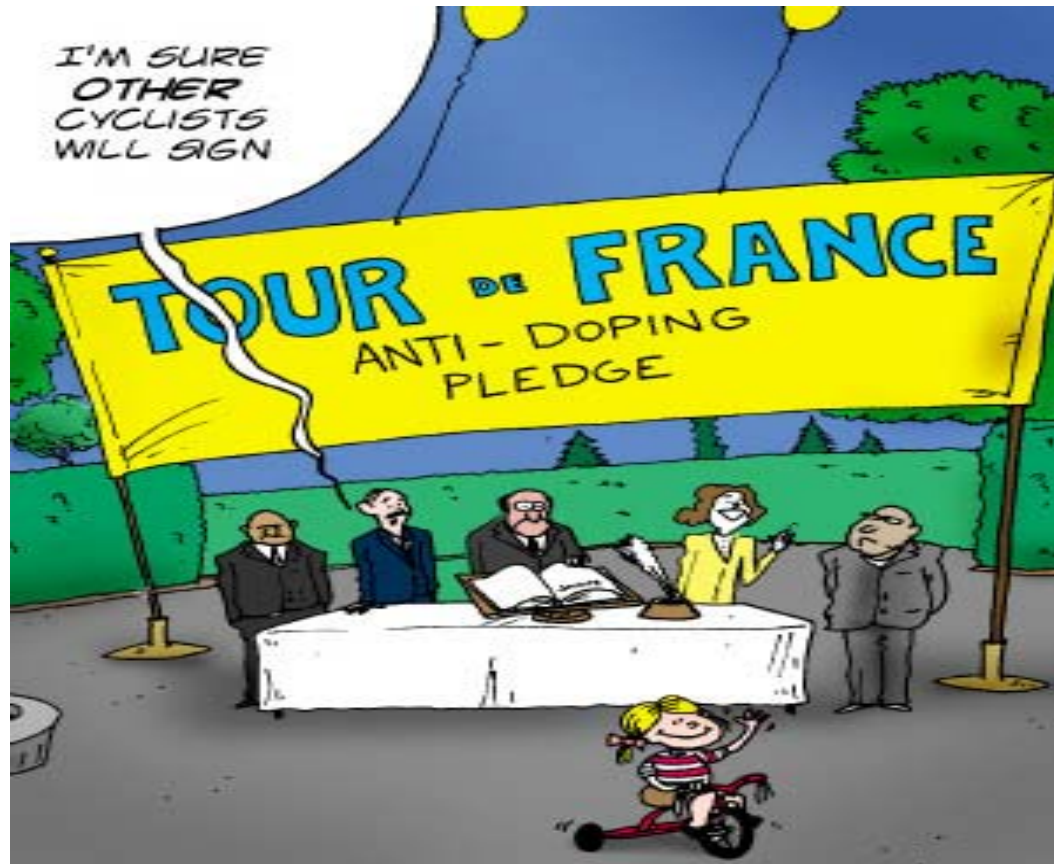
1. Confess
2. Stay silent

Prisoners Dilemma

TOM

		TOM	
		Stay silent Cooperate	confess Defect
T A N Y A	Stay silent Cooperate	Both stay silent, Both get token Sentence (1,1)	Tom goes free Tanya does serious Time (sucker) (5,0)
	confess Defect	Tanya goes free Tom does serious Time (sucker) (0,5)	Both betray each Other and confess Both get early Parole (3,3)

Even WITH information, what is rational for the individual may be irrational for society as a whole



Is the Kyoto Treaty a Higher Authority? (payoff is economic/short term)

		Cooperate	Defect
Cooperate	No Doping, low Payoff expected	Column Dopes, Row doesn't, Row is a sucker and loses	
Defect	Row dopes, column doesn't, Row wins, column loses and is a sucker	Everyone dopes, no one Wants to be a sucker, Everyone has high expectations of winning	

A Higher Authority is needed...

- To impose costs on doping that are higher than the benefits
- Would Friedman and Hayek agree?
- It worked in 2013



Each of us, acting rationally,
contributes to climate change

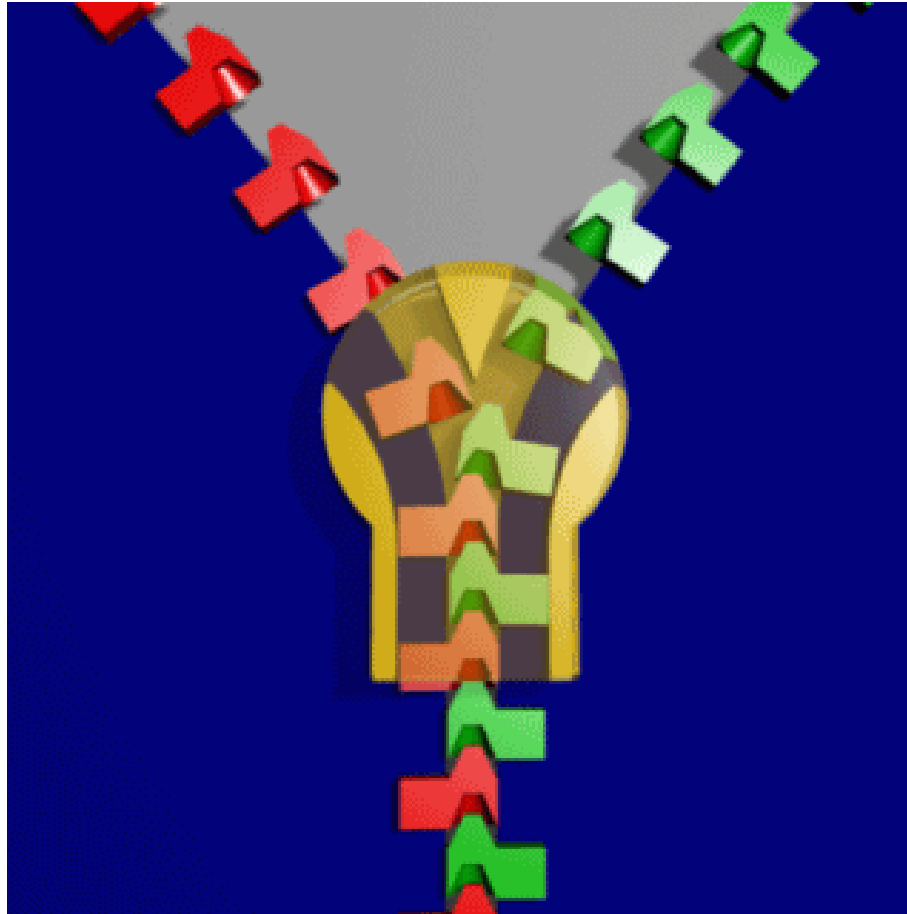
Economic Goals seem more rational



Is the Kyoto Treaty a vehicle for cooperation?

		Cooperate	Defect
Stay silent	Cooperate	All sign and adhere to the treaty: best for climate	You sign, others Don't... You are A sucker—noone is better off
confess	Defect	You sign, others Don't... You are A sucker noone is better off	All defect everyone is worse off. Worst outcome of all

Cooperation is optimal, but how do you get it?



You gotta have trust

- hard to move from the low-trust situation, to the more trusting situation.
- You try to achieve what you want on your own because risk that others will defect.
- trust lowers your perception of risk

So how do you get it?

Can Trust be Achieved?

The Problem of Collective Action

rationality is different in large and small groups

LARGE GROUPS

- the typical participant won't cooperate that much—it's not rational
- No social costs for narrow self-interested behavior
- Large groups trying to cooperate can't act efficiently
- Selfless behavior is not even praiseworthy.

SMALL GROUPS

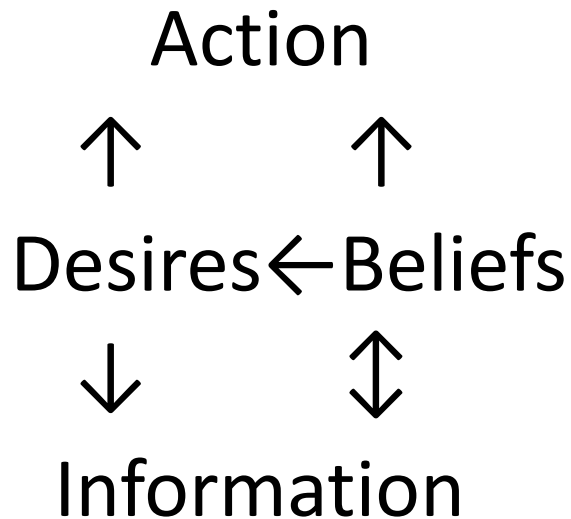
- More social incentives
- Selfless behavior is rational
- Transparency
- Reputation
- Social pressure
- Interaction
- Trust
- consensus

Prisoners Dilemma can be overcome in a small group if communication is possible and interaction long-term

NUCLEAR ARMS RACE

	Cooperate	Defect
Cooperate	US-Russia Communication Transparency Reputation trust	
Defect		IRAN NORTH KOREA

Important role of Information



But Good information is difficult to get in Large Groups

Information is difficult to get in large groups and large groups encourage “free riders”



Rational Actors have no incentive to cooperate in large groups



Who Cares anyway?

- Economic liberals believe that “large group” rationality is endemic to human nature;
 - Economic liberals believe that
 - Most incentives encourage narrow, self-interested rationality
 - Our very nature discourages cooperation
- Good because.....
- Markets depend on self-interest and competition to provide the efficiency that produces wealth

But even economic liberals believe that competition isn't always rational, and institutions (states) can help

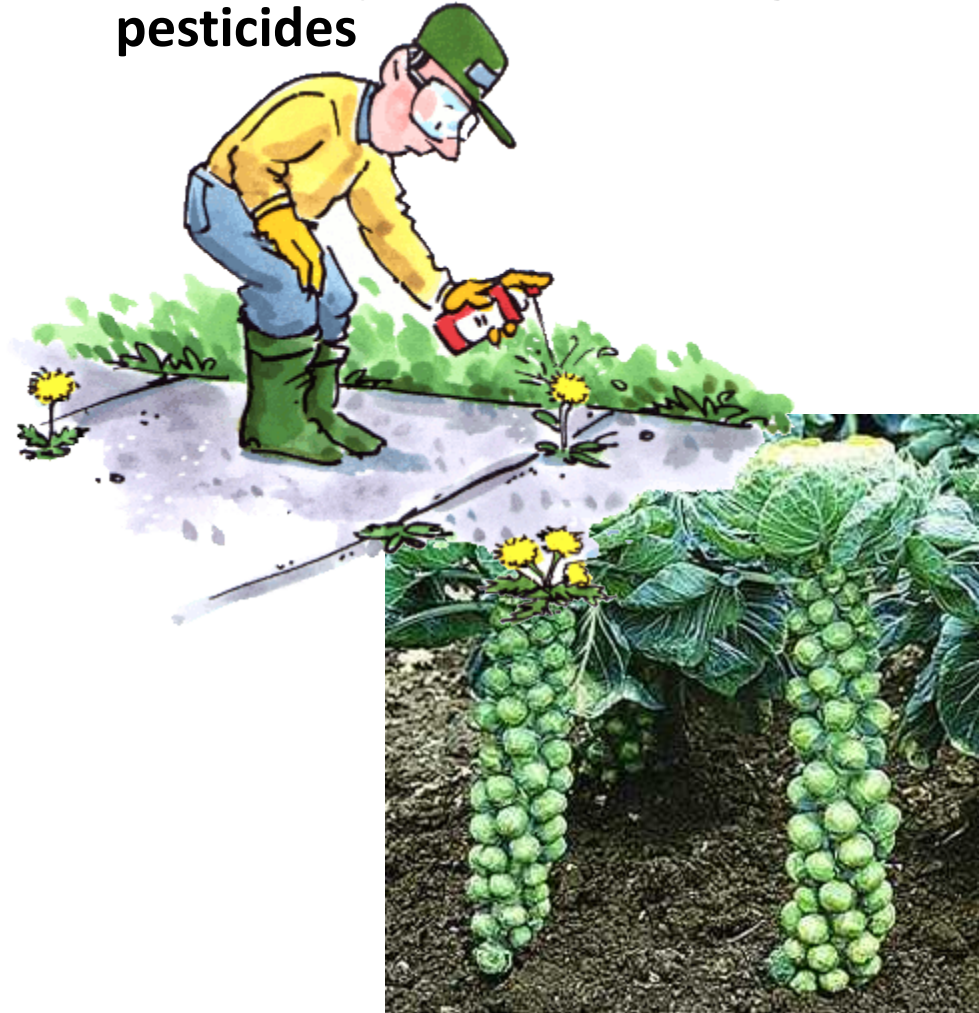
- reasons even economic liberals think cooperation might be necessary in a market system :
 - Reduce fraud and cheating
 - Mitigate externalities (neighborhood effects)
 - Create public goods
 - You need cooperation to create Trust.
Why?

The Libertarian's answer to state coordination: Coase Theorem



Libertarians (economic liberals) say Governments don't have good information and they make mistakes

Brussels Sprouts Farm using pesticides



Herb Farm that wants organic certification



Let's look again at the problem of illegal drugs and try to bring all these things together



What would the Coase theorem say?



Did we show all of this clearly?

- Competition is an essential feature of markets
 - Good because markets coordinate without cooperation
- Why it's rational to compete
- Why it's rational to compete in large groups
- Why cooperation is sometimes better than competition
- How can you get cooperation?
 - Government Authority (political Liberals)
 - Coase Theorem (economic liberals)

The End

Review http://www.huffingtonpost.com/2011/01/25/obama-state-of-the-union-1_n_813478.html

- When should the state Take positive action?
 - Intervene in markets when they fail?
 - Regulate in order to minimize externalities?
 - Provide public goods?
 - Provide social safety nets for those who cannot participate in market allocation?
- Liberals are split between those who want the government to protect the market (economic liberals or libertarians) and those who want it to take positive action (political liberals)