

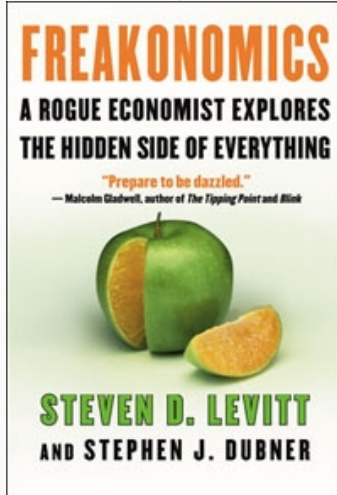


FREAKONOMICS

A Rogue Economist Explores The Hidden Side Of Everything

By Steven D. Levitt and Stephen J. Dubner; HarperTorch 2006

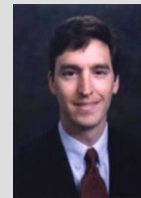
In the 1990s, violent crime rose in America and experts predicted it would continue to rise phenomenally. And then, suddenly, the crime rate fell. Experts then said this was because of better gun control laws, better policing, and the economic boom. But the theories were wrong. The real reason was that 20 years earlier, abortion became legal. And children who would have been born in a d v e r s e environments and thus were more likely to become criminals, were not being born anymore.



This is what "Freakonomics" by economist Steven D. Levitt and journalist Stephen J. Dubner is all about. It looks at the world and how it works by exploring "the hidden side of everything." It challenges conventional wisdom and proves that it is often wrong. It asks fresh, interesting questions most e c o n o m i s t s wouldn't even think about, such as: If drug dealers have so much money, why do they still live with their moms? Or which is more dangerous, a gun or a swimming pool?

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About the Authors:



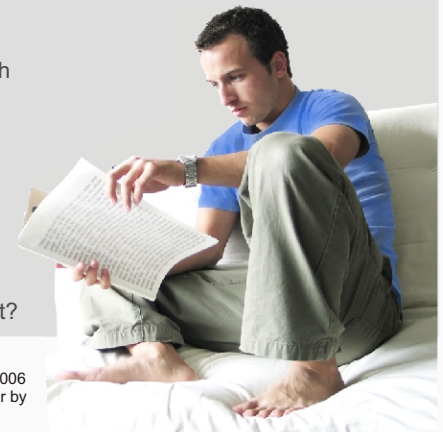
Steven D. Levitt is a prominent American economist best known for his work on crime, in particular on the link between legalized

abortion and crime rates. Winner of the 2003 John Bates Clark Medal, he is currently the Alvin H. Baum Professor of Economics at the University of Chicago and the director of the Becker Center on Chicago Price Theory at the University of Chicago Graduate School of Business. He is one of the most well known economists amongst laymen, having co-authored the best-selling book *Freakonomics* (2005). Levitt was chosen as one of Time Magazine's "100 People Who Shape Our World" in 2006.

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I. The Hidden Side Of Everything

Levitt is a young, brilliant, multi-awarded economist whose gift is to ask interesting, unexpected questions and find new insights about how the world really works. Using economics and its tools for measuring data, Levitt, in collaboration with Dubner, strips a layer or two from the surface of modern life to see what happens underneath and shows us that life is even more intriguing than we think.

For Levitt, morality represents the way people would like the world to work. Economics represents how the world actually works. So first, the book offers five fundamental insights using economics.

One, incentives are the cornerstone of modern life. And understanding them is the key to solving any riddle of human behavior or event.

Second, the conventional wisdom is often wrong. While we often accept explanations and theories from experts as fact, these are often not scientific at all. For example, drinking eight glasses of water a day has never been proven to do a thing for your health.

Third, dramatic effects or events, often have distant, even subtle, causes. For example, the drop in the crime rate was not caused by any recent efforts at policing but by the abortion law passed two decades earlier.

Fourth, experts use their informational

advantage to serve their own agenda. From real estate agents to scientists, most experts have their own biases in favor of self-interest. This means they don't always put your best interest first.

Fifth, knowing what to measure and how to measure it makes a complicated world much less so. This means that, despite the chaos and seeming unpredictability of the modern world, it is understandable if we learn to look at the data in the right way.

Incentives Are the Cornerstone of Modern Life

An incentive is simply a means of urging people to do more of a good thing and less of a bad thing. From childhood, we all learn to respond to incentives, positive or negative. If you get good grades in school, you get a new bike. If you break curfew, you're grounded. If you do well on your SATs, you get to go to a good college. If you flunk out of college, you have to take a miserable job. If you do well at your work, you get promoted.

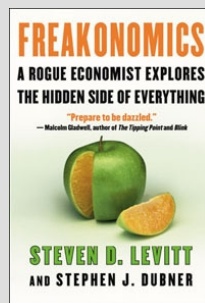
Economics, at its root, is the study of incentives how people get what they want, or need, especially when other people want or need the same thing.

There are three basic flavors of incentives moral, social and economic. Very often, an incentive scheme will have all three varieties. For example, the anti-smoking campaign imposed a \$3-sin tax as an economic incentive against buying cigarettes. In addition, smoking was banned in restaurants and other public places; this was a social incentive. At the same time, government asserted that terrorists raised money by selling black-market cigarettes, which was a moral incentive against smoking.

Conventional Wisdom Is Often Wrong

People often lament that there is so much crime in modern society and say it was more peaceful in the "good old days." But this is far from true if you take the long view. Statistics show that, compared to the 18th and 19th centuries, or

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even the 1900s-1950s, crime is considerably lower today.

And again, this is because of incentives. Compared to earlier times, we have more moral, social and economic incentives today, against committing crime. We have economic incentives (losing job and income from going to jail), social incentives (the fear of being seen by others as a criminal), and moral incentives (we don't want to do something we consider wrong).

Or take the conventional wisdom that money often buys elections. But if you look at the data on candidates who run against each other in various elections, the amount of money they spent hardly matters at all. What really matters is now how much a candidate spends; what matters is who he/she is in the eyes of voters.

Dramatic Effects Often Have Distant, Even Subtle Causes

We already learned that one major reason behind the crime drop was the law legalizing abortion. Another example of a distant cause that is causing a dramatic effect is the invention of crack cocaine in the 1970s.

Before then, the civil rights movement in America had made great progress in making life better for black Americans, in terms of healthcare, education, job opportunities, etc. But when crack cocaine (cheaper form of cocaine) was invented, the job of distributing it to the masses feels to black street gangs.

Crack cocaine set back blacks' progress in America by about 10 years. Infant mortality again soared after declining for years, and crime waves in black neighborhoods increased. On a national scale, crack cocaine contributed to a rise of a nationwide crime wave in America.

Experts Use Their Advantage To Serve Their Own Agenda

Take real estate agents, for example. You hire an agent to sell your home because you think

she/he would know better than you know how to do it, and get you the best price possible.

But real estate agents are human, and they respond to incentives. When a real estate agent sells your home, she/he makes you take the first good offer that comes along. This is because it doesn't make much of a difference to her commission, if you get a slightly better offer later. She/He just wants to close the deal as quickly as possible, so she can move on to the next deal. When a real estate agent is selling her/his own home, she/he holds out longer, and waits for the best possible offer.

This is also why a medical study revealed that obstetricians in areas with declining birth rates are more likely to perform caesarian section deliveries they try to make up for less business with more expensive procedures. And also why some mechanics pass up of repair bills and let some cars pass their emission tests. They know this is rewarded with repeat business.

II. The Question of Cheating: What Sumo Wrestlers and Teachers Have in Common

One of the questions Levitt asks is: Who cheats and why? Well, his studies show that even those who seem most honorable, or who seem to have the least opportunity to do so, often cheat, because of incentives. This is what sumo wrestlers and schoolteachers have in common.

Cheating on Standardized Tests

In a study of the Chicago public school system, Levitt found that a significant percentage of teachers helped their students pass the annual standardized tests. Why? Because the system provides incentives to schools and teachers whose students get high scores.

Under the No Child Left Behind policy in American education, schoolchildren who get low scores on the standardized tests get held back a year. In



addition, a school that gets low scores can get its funding cut or face closure, and a schoolteacher whose students get low scores can get demoted or fired. Conversely, schools which do well on the tests get more funding while teachers whose students get good scores can get promoted or receive cash bonuses.

But how to measure if teachers are cheating? Levitt and Dubner looked at a database of test answers by students from the third to seventh grade from 1993 to 2000. This amounted to roughly 30,000 students per grade per year, more than 700,000 sets of answers, and nearly 100 million individual answers.

Then they looked for unusual answer patterns in a given classroom, such as blocks of identical answers, especially for harder questions, or a student giving right answers for hard questions, while missing the easy ones. The study found such unusual answer patterns and theorized that some teachers may have changed students' answers after they took the test.

To test the theory, students of teachers suspected of cheating were asked to take a retest, with a control group of students who did well in the test but were not suspected of having their answers changed. The result was: the students who were not suspected of cheating did the same or better on the retest, while the students whose teachers were suspected of cheating did much worse on the second test. As a result, several of the suspected teachers were fired and those who weren't got a powerful incentive against cheating again.

Sumo Wrestling

Sumo wrestling is another field that is found to be prone to cheating. Sumo is the premier sport in Japan, one that is considered to be sacred and honorable. But the incentives scheme in sumo makes it highly prone to cheating. Each sumo wrestler needs to maintain a ranking that affects how much he earns, what privileges and reputation he enjoys.

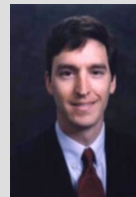
To maintain his ranking, he needs to win at least 8 victories out of 17 every year. On the final day

of tournament, some wrestlers will have 7-7 cards, meaning they have 7 wins and 7 losses, and need to win their final bout to maintain their ranking.

Interestingly, wrestlers with 7-7 cards often win by 80% against wrestlers who have 8-6 or 9-6 cards, even though odds often put their chances at less than 50%. This indicates that some match rigging may be going on. Of course, one can argue that wrestlers with 7-7 cards try harder to win because they have more at stake.

However, if one looks at the win-loss percentage of the same wrestlers the next time they fight, the

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University of Chicago Graduate School of Business. He is one of the most well known economists amongst laymen, having co-authored the best-selling book *Freakonomics* (2005). Levitt was chosen as one of Time Magazine's "100 People Who Shape Our World" in 2006.

He attended St. Paul Academy and Summit School, graduated from Harvard University in 1989, and received his Ph.D. from MIT in 1994. In 2003 he won the John Bates Clark Medal, awarded bi-annually by the American Economic Association to the most promising U.S. economist under the age of 40. In April 2005 Levitt published his first book, *Freakonomics* (coauthored with Stephen J. Dubner), which became a New York Times bestseller.



Stephen J. Dubner is an American journalist who has written three books and numerous articles. Dubner is best known as co-author (with economist Steven Levitt) of the pop-economics book *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything*.

Dubner's book, *Freakonomics*, was required reading for all freshmen entering Appalachian State University for the fall of 2006.

To know more about the author and this book, please visit <http://www.freakonomics.com>



data shows that the 7-7 wrestlers win only 40% of the time against the same opponents. The most logical explanation is that some quid pro quo had been reached between the players, something like: you let me win today, and I'll let you win the next time.

This theory, however, has always been denied by sumo officials in Japan and no wrestler has ever been punished for cheating.

III. The Fact Of Honesty

While Levitt's studies show that people do cheat even when it's hard to prove it, he also asserts that a larger percentage of people don't. People's honesty is shown in the story of Paul Feldman, a man who started a business selling bagels. Feldman sold bagels through an honor system: he would leave baskets of bagels in an office, as well as a collection box. Whoever took a bagel would then need to drop a dollar in the box.

While Feldman's economist-friends told him his system would never work, Feldman found that his payment rate was approximately 87%. This means that while not everyone paid for the bagels, 87% of people did.

He also found out that smaller offices were more honest than big offices, probably because a non-payer would be more likely to be known in small offices (again, a social incentive against non-paying).

Executives, Feldman discovered, also tended to be more dishonest about paying than lower-ranked employees. Delivering bagels to three different floors that comprised the executive, administrative and sales departments, Feldman found that the executive floor had a lower payment rate than the other floors. This could be due either to executives having an over-developed sense of entitlement to things (including bagels) or maybe because cheating was how they got to be executives in the first place.

IV. What the Ku Klux Klan and Real Estate Agents Have in Common: Using and Abusing Information

The Ku Klux Klan and real estate agents have one thing in common: both use information to gain power over others.

The Klan was founded just after the Civil War to promote white supremacy, first against blacks, then later against blacks, Jews and other races. It grew in the first decade of the 20th century, then declined during the first World War, when national unity became a stronger motivation than segregation. The Klan thrived after the War, when fear of war was replaced by uncertainty about the economy.

What finally caused the downfall of the Klan? Information. The Klan, fundamentally, derived its power and appeal from being a secret society. It had secret passwords, secret handshakes, and members who were only known to each other. While a lot of people spoke against the Klan, they knew very little about it.

Stetson Kennedy, an anti-racial advocate, found a way of eliminating the Klan once and for all. He infiltrated the Klan. He became a member, learned all its secret ways, and found out that the chapter he joined was basically a group of poorly-educated, low-earning men who needed a space to vent their frustrations and occasionally a reason to stay out all night..

Learning this, Kennedy passed on everything he knew about the Klan to the Superman comic book writers. Superman comics then wrote a series about Superman fighting the Klan, and used the Klan's secret passwords, codes, etc. Soon, children all over America knew all about the Klan and turned the secret society into a child's game. Members became disgruntled and humiliated and stopped attending meetings. Their secret society had become a mockery and had lost its appeal and power for them.

Real estate agents operate in the same way. You go to them thinking they can help you sell your home for the best price. But real estate agents



also use code words and information to serve their interests. Again, a real estate agent's first interest is to sell your house as quickly as possible. So she/he isn't going to wait around for the best offer. In fact, they could tell prospective buyers how much lower you could go on your price, just to facilitate the sale.

At the same time, real estate agents also markets houses in a unique way. When an agent says a house is "well-maintained", you may think that's a good way to describe your house. But "well-maintained" is actually a code word to tell prospective buyers that a house is old but is not actually falling down yet.

Other code words that agents use to subtly disparage a house their selling and hint to buyers to buy low are: "spacious", "fantastic", "good neighborhood" and other ambivalent adjectives.

If an agent really wanted to say that a house was a great buy and command a higher sales price, she/he would use words like "granite", "maple", "Corian," "gourmet" or "state of the art", or other words that are more specific in describing the house.

V. Why Do Drug Dealers Live With Their Moms: Challenging Conventional Wisdom

Conventional wisdom is that which is simple, convenient, comforting and comfortable, that which closely accords with our self-interest or well-being and would be the least awkward or unwelcome.

But much conventional wisdom is actually false, and often spun by so-called experts and advocates with a cause to promote, and the media with news to sell. Such a system has spawned such lies as: 45 homeless Americans die every second, one in three women will be a victim of assault in her lifetime, or that Listerine cures bad breath.

Before Listerine, bad breath was not in people's consciousness and was not seen as much of a problem. The actual statistic is that one in eight women will be a victim of assault. And if 45 homeless people died every second, there would be 1.4 billion dead homeless every year, whereas the US population is only 225 million at the time the news was made.

Another myth spurned by police in America is that drug dealers were armed with state of the art weapons and limitless cash. But if you look at housing projects where crack cocaine is often sold, you would see that many drug dealers still lived at home with their parents. Why is that, if they had so much money?

Sudhir Venkatesh was a sociologist who lived with a black youth gang in Chicago for many years, learning their ways and understanding their way of life. As a result, Venkatesh was given the books for gang's drug sales for the last seven years.

Teaming up with Levitt, the two then discovered that the gang's organization was almost identical to McDonald's, or any other corporate organization in America. That is, the group operated like a pyramid, with a few earning most of the money and the rest getting peanuts while doing the most dangerous part of the job.

VI. What do nylon stockings and crack cocaine have in common?

In 1939, Dupont introduced nylon stockings for women. Until then, there were only silk stockings available, which were expensive and hard to come by, making them inaccessible for most women. Nylon stockings made it possible for women to wear stockings all the time.

It was the same with crack cocaine. In the 1970s, cocaine was the classiest drug. But it was also the most expensive so few drug users could afford it. Then crack cocaine was invented, which was simply mixing small



quantities of cocaine with baking soda and water and then cooking off the liquid.

The invention of crack cocaine coincided with a cocaine glut in Colombia. And an enterprising Nicaraguan, Oscar Danilo Bandon, figured out how to make use of the two to make money. He brought in large volumes of cocaine, and distributed it to predominantly black street gangs to turn into crack cocaine and sell on the streets.

Overnight, crack cocaine became the most popular drug in America. It was cheap, provided a powerful high that didn't last long, so always sent the customer back to buy some more.

VII. Drugs and the Setback in the Black Movement

Until crack cocaine entered the scene, Blacks as a group in America were gaining great strides in terms of civil rights, health, opportunities and economic power. But crack cocaine's destructive effect was felt hardest by blacks. When crack cocaine infiltrated black neighborhoods, infant mortality and crime soared in these communities.

On a larger scale, crack cocaine contributed to the larger crime wave that started building in America until the mid-1990s until it was stopped by another unexpected cause the abortion law.

VIII. Which is more dangerous: a gun or a swimming pool?

Most parents would not keep a gun in the house for fear that it can cause harm to their children. Few parents, however, would think there is nothing wrong with having a swimming pool at home.

Data shows, however, that there is one drowning of a child for every 11,000 residential

pools in America. In a country with 6 million pools, this means that roughly 550 children under the age of ten die of drowning every year.

Meanwhile, there is a child killed by a gun for every 1 million guns. In a country with an estimated 200 million guns, this means roughly 175 children under ten die from guns each year.

This shows that the risks that scare people are very different from the risks that actually kill people. In simple terms, some risks are more frightening than others. A terrorist attack, for example, is more frightening, than heart disease, even though more people die of the latter. And a swimming pool is less scary than a gun.

In other words, risk is viewed by people as: $\text{Risk} = \text{Hazard} + \text{Outrage}$. If the hazard is high but the outrage is low, people tend not to react too much, such as in the case of heart disease. But if the hazard is low and the outrage is high, such as for terrorist attacks, then people tend to overreact.

IX. What Makes the Perfect Parent?

Many books and studies have been written and disseminated on what parenting would be best for children. There is no single answer but Levitt found interesting correlations between how a child's school performance (as seen in test scores) and his family environment.

In a nutshell, children's test scores were strongly correlated or affected (positively or negatively) by eight other factors in their family life:

- The child has highly-educated parents (positive)
- The child's parents have high socioeconomic status. (positive)
- The child's mother was thirty or older at the time of her first child's birth. (Positive)



- The child had low birth weight (negative)
- The child's parents speak English at home. (Positive)
- The child is adopted. (negative because parents who give up their babies for adoption tend to have lower IQs)
- The child's parents are involved in the PTA. (positive)
- The child has many books at home. (positive)

This may indicate that parenting techniques may be overrated. That it doesn't matter so much what you do, as who you are. 🧠

Other factors that do not correlate at all with good test scores, which seem to indicate that they do not matter or affect a child's school performance, are:

- The child's family is intact.
- The child's parents recently moved into a better neighborhood.
- The child's mother didn't work between birth and kindergarten.
- The child attended Head Start.
- The child's parents regularly take him to museums.
- The child is regularly spanked.
- The child frequently watches television.
- The child's parents read to him/her nearly every day.

If you look more closely, the first list describes things that parents are. The second list describes things that parents do. Parents who are well-educated, successful and healthy tend to have children that do well in school. It doesn't seem to matter if they take the child to museums or read to him every day or make him watch TV or not.

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