

Institutions shape the available choices

Institutions are formal and informal rules that structure interaction: ownership arrangements, contracts, customs, organisational rules and enforcement practices. Organisations are groups operating within or changing those rules. Institutions influence information, incentives and transaction costs. Every numerical situation here is illustrative, and the lesson explains economic concepts rather than rules of any particular legal jurisdiction.

Property rights specify permitted uses

Property rights describe claims about using, excluding others from, benefiting from and transferring resources. Different rights can be separated or conditional. Clear and secure rights can support planning and investment, but defining boundaries and addressing conflicts can be costly. Economic effects and the moral legitimacy of a particular allocation of rights are separate questions.

Contracts make plans conditional on agreement

A contract records agreed obligations, such as delivery, payment, quality and timing. Better specification can reduce misunderstanding, but writing and enforcing every possible contingency is costly. Incomplete contracts leave some future situations unspecified. Reputation, warranties, repeated dealings and dispute procedures can supplement formal terms, each with its own limitations.

Transaction costs change the gains from cooperation

Search, measurement, negotiation, monitoring and dispute resolution use resources. These transaction costs can prevent a trade whose gross benefits exceed production costs. Intermediaries, standards and organisations may reduce some costs while introducing others. Compare total relevant costs, including time and expected failures, rather than selecting the arrangement with the smallest visible fee.

Incentives depend on who receives consequences

A person who expects to keep benefits from improving a resource may have a stronger reason to invest in it. Someone who expects others to bear its costs may take too little care. These are conditional incentive mechanisms, not universal descriptions of human motivation. Norms, preferences, monitoring and the security of claims also matter.

External effects cross the transaction boundary

An externality is an effect on people outside the decision that is not fully reflected in the decision-maker's relevant costs or benefits. Pollution and uncompensated spillover learning are common examples. A price change that affects another seller is not automatically the same kind of externality. Specify the mechanism, affected people and missing incentive.

Worked example: a private output decision

An illustrative workshop can make up to five batches. Additional benefits after all private resource costs are £16, £12, £8, £4 and £1. With no other private consequence, all five add positive value to the owner. Total private net benefit is £41. Now suppose each batch also causes £6 of uncompensated harm to neighbours.

Worked example: include the external cost

Subtract £6 of harm from each batch's private increment. Combined net increments become £10, £6, £2, minus £2 and minus £5. Three batches maximise their summed net value at £18. Five batches give £41 of private benefit minus £30 of harm, or £11. The fourth and fifth reduce the combined total.

Bargaining may help, but conditions matter

If affected parties can identify one another, specify enforceable rights and negotiate cheaply, they may agree on changes that create mutual gains. Bargaining outcomes also depend on initial rights and available alternatives. Many parties, uncertain damage, holdouts, free riding or enforcement problems can block agreement. Potential compensation is different from consent and actual compensation.

Public goods have two technical properties

A public good is non-rival over the relevant range and difficult to exclude non-payers from using. One person's benefit does not substantially reduce another's, and selective access is costly. These properties create a possible free-rider problem. "Public good" does not simply mean beneficial, publicly owned or supplied by government.

Worked example: funding a shared light

Three neighbours value an illustrative shared light at £18, £15 and £11. Provision costs £36. Total stated benefit is £44, leaving an £8 net gain. Equal £12 shares would exceed the third neighbour's benefit. Contributions of £14, £12 and £10 cover the cost and leave individual gains of £4, £3 and £1.

Compare realistic institutional alternatives

Possible responses include clearer rights, contracts, voluntary associations, reputation systems, pricing mechanisms, liability, rules and collective provision. Each requires information, administration and enforcement. Compare how alternatives perform on the actual problem, including errors and side effects. An imperfect existing arrangement should not be judged against an imagined alternative that has no costs or mistakes.

Knowledge and power need scrutiny everywhere

Markets, firms, associations and governments all operate with limited information and imperfect incentives. Competition, transparency, accountability and exit can improve some arrangements, but their availability varies. Private market power and public decision-making power both deserve examination. Institutional analysis should explain mechanisms and evidence rather than assume benevolence or competence from an organisation's label.

Keep efficiency and legitimacy distinct

An efficiency calculation asks what consequences follow under stated assumptions and an evaluative measure. A rights-based judgement asks which actions and claims are permissible. Neither is identical to fairness, consent or total money income. A defensible recommendation identifies affected people, relevant rights, feasible alternatives, enforcement costs, uncertainty and the values guiding the decision.