

Rights, contracts and institutional choices

Examine how rules support cooperation, why externalities and public goods create challenges, and how to compare realistic institutions while distinguishing efficiency from rights.

Written walkthrough. Work through each explanation alongside the PDF slides. The lesson page also includes a captioned video with a generic synthetic narrator. It is not a recording of Craig Wright.

Fictional examples teach reasoning rather than describe a real business. No external academic credit is awarded.

Learning objectives

1. Explain property rights, contracts and transaction costs as institutional mechanisms.
2. Identify external effects and public-good properties precisely.
3. Calculate illustrative private and combined consequences without treating monetary sums as complete moral judgements.
4. Compare feasible institutional alternatives using explicit evidence, costs, consent and rights criteria.

Slide 1: 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.

Walkthrough

Compare two markets selling the same product. In one, sellers' identities and terms are clear and disputes can be resolved cheaply. In the other, neither party knows whether promises will be honoured. Even with identical technology, the feasible trades and their costs can differ. Institutions help explain that difference. Some rules are written and enforced through courts or organisations; others rely on repeated interaction and reputation. Do not assume that a formal rule is effective merely because it exists on paper. Actual enforcement, expectations and informal practices also shape behaviour.

Slide 2: 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.

Walkthrough

Owning a resource is not always a single unlimited permission. A tenant may have a right to use a workshop without a right to sell the building. A neighbouring owner may have a competing claim about harmful noise. The exact legal details vary, so our concern is the general economic mechanism: predictable claims can reduce uncertainty and make longer-term arrangements possible. They can also determine bargaining positions and who must obtain consent. Calling a right clear does not establish that its origin was just, nor does showing a useful incentive settle every rights-based objection.

Slide 3: 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.

Walkthrough

Suppose a buyer orders a custom desk. Stating the dimensions, material and delivery date narrows the space for disagreement, but unexpected damage or supply disruption can still occur. A detailed agreement costs time to prepare and may not anticipate every relevant event. The parties need a way to interpret terms and respond to surprises. These arrangements influence the attractiveness of exchange. This is not a claim that any informal promise is legally enforceable; enforceability depends on applicable rules and facts. The economic question is how the arrangement changes expected costs, trust and feasible cooperation.

Slide 4: 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.

Walkthrough

A platform charging five pounds may still be cheaper overall if it saves an hour of search worth more than five pounds. Conversely, a zero-fee arrangement may expose participants to expensive disputes or poor information. Some activities are organised inside firms partly because repeated market negotiation would be costly; internal management also creates coordination and incentive costs. Neither markets nor organisations are costless defaults. Identify the task, the realistic alternatives and the margins on which their costs differ. Include uncertainty about quality rather than treating a promised service as identical to a reliably delivered one.

Slide 5: 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.

Walkthrough

Consider a shared garden. Participants may invest because they enjoy gardening, care about neighbours or expect future produce. A rule assigning plots might improve incentives in one setting and undermine useful cooperation in another. The relevant comparison depends on which problems are actually present and what arrangements are feasible. A liberty-oriented perspective values personal agency and consent; empirical analysis asks how particular rules affect stewardship and conflict. Avoid assuming that people respond only to money or that every collective arrangement fails. Equally, good intentions alone do not guarantee that a system handles incentives well.

Slide 6: 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.

Walkthrough

A workshop's fumes may harm nearby residents even if buyers and sellers are satisfied with the furniture transaction. The harm falls outside the private comparison unless some institution brings it into the decision. By contrast, a new competitor lowering an incumbent's profits through a lower market price is not, by that fact alone, a technological externality. Economic analysis distinguishes these mechanisms because their implications differ. Estimating an external effect requires evidence about causation and magnitude. Calling something an externality does not by itself identify the best response or resolve whose rights should constrain the activity.

Slide 7: 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.

Walkthrough

Start with the private decision before adding the external effect. Add the five net increments: sixteen plus twelve plus eight plus four plus one equals forty-one pounds. Because every increment is positive, the owner prefers five batches to fewer under the stated assumptions. The neighbours' harm is not part of that private calculation. We are not assuming the harm is acceptable or that the workshop has a legitimate right to impose it. We are making the incentive gap explicit so that a later institutional comparison can address both consequences and rights.

Slide 8: 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.

Walkthrough

Compute each affected margin rather than merely comparing average harm with average benefit. The first batch adds sixteen minus six, or ten. The next adds six, the third adds two, the fourth loses two and the fifth loses five. Cumulative totals are ten, sixteen, eighteen, sixteen and eleven. Three batches therefore maximise this particular monetary sum. That conclusion assumes the valuations are meaningful, all relevant effects are included and the options are feasible. It does not prove that monetary gains can ethically cancel someone else's rights violation or that the best enforcement arrangement is known.

Slide 9: 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.

Walkthrough

Suppose a noise-reduction measure costs less than the total harm it would prevent. There may be room for an agreement that funds the measure and leaves participants better off. But someone must identify the harm, agree on obligations and verify the outcome. Initial rights influence who can demand payment and who must obtain permission. A stylised result about costless bargaining does not establish that bargaining is costless in practice or that the initial allocation of rights is irrelevant to distribution. Assess the real obstacles before recommending either private negotiation or another institutional response.

Slide 10: 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.

Walkthrough

An uncongested local warning signal can benefit several people at once, and excluding a nearby listener may be difficult. By contrast, a publicly operated swimming pool can become crowded and can charge admission. It is not a pure public good merely because a public body runs it. Some goods are partly rival or partly excludable, and technology can change these properties. Free riding arises when someone can benefit without contributing, potentially weakening incentives to fund provision. That is a mechanism to analyse, not proof that voluntary provision never occurs or that compulsory provision always succeeds.

Slide 11: 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.

Walkthrough

First add the benefits: eighteen plus fifteen plus eleven equals forty-four. Subtract the thirty-six-pound cost to obtain eight pounds of possible combined gain. Then test a proposed funding rule. Equal shares cost each person twelve pounds, which the third values more than their eleven-pound benefit, so unanimity is not established. The alternative contributions sum to thirty-six and are each below the respective benefit. This demonstrates a feasible individually beneficial allocation under the supplied valuations. It does not prove people will reveal valuations truthfully, contribute as promised or organise the arrangement without further costs.

Slide 12: 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.

Walkthrough

For a pollution problem, a numerical charge may create incentives but require information about damage and reliable enforcement. A performance rule may be easier to verify in some settings but less flexible in others. Bargaining may work well with a few identifiable parties and poorly with dispersed populations. Voluntary associations may use local knowledge but face participation problems. These possibilities are analytical categories rather than legal recommendations. A careful comparison asks who knows what, who decides, who pays, how disputes are resolved and what happens when the institution itself performs badly.

Slide 13: 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.

Walkthrough

A regulator may lack local cost information; a firm may conceal product quality; an association may be dominated by a few members. These are different problems requiring different safeguards. The relevant question is which feasible arrangement handles the particular information and incentive problems better, under the rights and objectives being considered. A liberty-oriented framework gives strong weight to consent and limits on coercion. It can still investigate actual outcomes rather than treating voluntary language as sufficient evidence that meaningful choice exists. Specify both the evaluative principles and the empirical claims instead of allowing one to stand in for the other.

Slide 14: 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.

Walkthrough

Return to the workshop example. The monetary calculation identified an output level with a larger combined measured surplus. It did not establish who should hold which rights, whether anyone may be compelled to accept harm, or which institution can implement a better outcome at acceptable cost. A recommendation should say what additional evidence and moral premises it uses. In the exercises, numerical responses check the supplied benefit and cost arithmetic. The ungraded written explanations are where you can discuss missing information and competing principles. They are deliberately not marked by a simplistic keyword rule.

Questions students ask

Does an externality automatically prove that a particular intervention is best?

No. It identifies a potentially missing incentive. A response must still be compared with realistic alternatives, including its information, enforcement, distributional and rights implications.

Can a privately organised group provide a public good?

Yes. Public-good properties describe rivalry and exclusion, not the supplier's ownership. Voluntary provision may work under some conditions, although funding and participation problems can remain.

Does a larger combined monetary gain override someone's rights?

That does not follow from the arithmetic. Whether and how rights constrain permissible actions is a normative question that must be addressed explicitly.

Your exercises

Submit your answers on the lesson page at craigwright.net/learning. Numerical and choice checks receive server feedback. Written responses are saved ungraded. No assessment answer key appears in this guide.

1. Calculate the gains after coordination costs

Illustrative one-off trade: the buyer values the item at £85 and the seller's opportunity cost is £55. Search, verification and enforcement use resources worth £6, £4 and £5 respectively. Calculate the gross potential gain and the gain after these transaction costs. Do not assume a particular division between the parties.

Gross potential gain (£)

Net potential gain (£)

2. Compare private and combined increments

Illustrative activity: four possible units have private net benefits of £20, £14, £9 and £3. Each unit causes an additional £7 of uncompensated external harm. Units must be taken in order and there are no other effects. Calculate the privately preferred quantity, the quantity maximising summed net value including harm, and that maximum summed value.

Privately preferred quantity (units)

Quantity maximising the stated combined measure (units)

Maximum combined net value (£)

Ungraded reflection: what moral or institutional question does this calculation leave open?

3. Test a shared funding proposal

Illustrative shared service: three people value provision at £21, £17 and £14. Cost is £45. Calculate total stated benefit and combined net benefit. Then ask whether an equal three-way cost split gives every person at least as much benefit as payment. Assume these valuations are accurate and no other effects exist.

Total stated benefit (£)

Combined net benefit (£)

Does every person weakly benefit from the equal split?

1. Yes, all payments are no greater than benefits
2. No, at least one payment exceeds its benefit
3. Cannot compare the supplied values

4. Compare like with like

Illustrative institutional comparison: arrangement A has administration costs £12, expected error costs £25 and delay costs £8. Arrangement B has corresponding costs £20, £10 and £6. Categories do not overlap. Calculate each total and B's cost saving relative to A. These figures alone do not measure rights or consent.

A's total cost (£)

B's total cost (£)

A's cost minus B's cost (£)

Ungraded reflection: identify one additional criterion needed for a defensible recommendation.