

**MARKET AND GOVERNMENT INSTITUTIONS: THE ECONOMICS  
OF EXCHANGE AND COOPERATION: ECONOMICS 3370**

Girton  
Fall 2014  
Off: OSH 344

Off. Hrs: Tue/Wed. 4:00-6:00, and by Appointment  
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*"Few things are harder to observe clearly...than the ordinary, everyday aspect of things."* Frederick Lewis Allen, Only Yesterday: An Informal History of the 1920s (1931)

STRUCTURE OF THE COURSE

Lectures and class discussion will cover the main topics. There is not an assigned text for the course. The reading list contains several items on each topic. Within each topic, the readings are ordered with the highest recommended readings first.

I do not expect that you will have time to cover all the readings. The reading list may guide you in writing essays, term papers, and book reviews.

We will focus on the theory and application of the economic topics covered. An important part of the class will be to apply the theories and concepts to practical examples drawn from everyday life. To practice applying the concepts and theories developed in the class, you should regularly read relevant newspaper articles. Also, reflecting on your own individual situation as an economic agent and social being should reinforce and make more concrete the concepts and ideas.

GRADE DETERMINATION

	Course Grade
1. Class Participation	30%
2. Written Work: Book Reviews, Essays, Term Papers, and assignments	30%
3. Final Exam (Take-Home)	40%

Thirty percent of your grade will be based on class participation. In determining this part of your grade I will look at the following: Did you regularly contribute to class discussion? Did you keep abreast of the lectures and readings? Were your comments and questions to the point and insightful; did they demonstrate a grasp of the subject matter?

The form of the written work is flexible. You can do book reviews, essays, and/or a term paper. Written work will get up to one and a half points per page.

## GUIDE FOR WRITTEN WORK

Papers: Written work, including research papers, essays, and book reviews, will be judged primarily on substance, but grammar and style are also important.

All written work must be typed and contain a careful documentation of sources. Your work should be clearly written and have a sound logical structure. This is facilitated by working from an outline and by rewriting. Poorly written work, that does not show a reasonable amount of care and attention, will not be graded.

Papers should be clearly organized, with structure and direction - again, work from an outline. The title of the paper should clearly indicate the subject (do not use cutesy titles). The first paragraph must give a clear description of the content of the paper. A clear and commonly used three part structure is: in the introduction say what you intend to do, in the body of the paper do it, and in a concluding section review or summarize what you have done. Paragraphs should usually begin with a topic sentence. Do not expect your first draft to be the best that you can do - write, read, critique, think about, rewrite.

Book Reviews: Book reviews should include a clear discussion of the following questions: Why was the book written - what was the purpose? What is the central argument of the book? What are the major points? What is the author(s) arguing against? How is the book related to the course? In addition to reporting, also evaluate and critique the book.

Guides to Clear and Effective Writing: Poor writing is vague, confusing, and a pain to read. Good writing is clear, simple, well organized, and to the point. To facilitate development of a clear and effective writing style you are encouraged to buy one or more of the following brief, and inexpensive, practical guides. The Elements of Style, by William Strunk and E. B. White, is the classic brief guide to clear and effective writing.

## **PART 1: INTRODUCTION AND BASIC MICROECONOMIC CONCEPT**

### **Aug. 27 INTRODUCTION AND SURVEY OF THE COURSE**

1. Objectives of the Class: To enhance your ability to think like an economist - to be able to use the economic approach to examine common everyday real world issues, and to understand the economic role of institutions in facilitating cooperation and mutually beneficial exchange.
2. What factors determine the proper roles of markets and government in the economy, i.e., in supporting economic cooperation and exchange between individuals?
3. Introduction to Market and Government Institutions  
— The Importance of Exchange Between Autonomous Individuals  
— The Role of Institutions and Organizations in Reducing Transactions Costs Between Self-Interested Individuals  
— The Role of the Market in Coordinating Economic Activity  
— Visible and Invisible Guiding Hands of Organizations and Markets in Providing Individual Incentives
4. From Adam Smith, *The Wealth of Nations*, "In civilized society he (the individual) stands at all times in need of the cooperation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons... But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and shew them that it is for their own advantage to do for him what he requires of them...It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."  
— There is little attention given by Smith in The Wealth of Nations to organizations, public or private, that facilitate cooperation and coordination of groups of individuals.
5. The Crucial Role of Institutions and Organizations in Economic Performance  
— Adam Smith: Division of Labor and Specialization produces growth (is the Engine of Growth). But specialization puts a heavy weight on interpersonal exchange and mechanisms coordinating individual activities and facilitating cooperation.
6. The 'Coase Theorem' and the Importance of Transactions Costs  
Douglas North: Application of the New Institutional Economics to the Development and "The New Economic History"
7. Imperfect and Asymmetric Information
8. The New Institutional Economics: Institutions and Organizations evolve to Reduce Costs of Cooperation and Coordination:  
According to North, "Institutions are the rules of the game and organizations are the actors in the economic game."
9. The Autonomous Individual vs the Group [On 'Methodological Individualism', see Hayek, Individualism and Economic Order, and von Mises, Human Action, p. 41-44 (4<sup>th</sup> revised ed., 1996). For a comprehensive essay see the article on "Methodological

Individualism" at [www.Plato.Stanford.edu](http://www.Plato.Stanford.edu).

- Decision Making by Self-Interested Individuals, given Social/Cultural Norms and Values, with Individuals Seeking After Peer Approval - The Role of Socialization
- 10. In a Pure Exchange Model, Transactions Costs Limit Exchange Between Individuals, i.e., Limit Specialization and Division of Labor, and Limit Economic Development and Growth
- 11. Outline of the Course

**Sept. 3 THE STANDARD ECONOMIC MODEL, BASIC MICROECONOMIC CONCEPTS, AND THE ROLE OF INSTITUTIONS**

- 1. The Standard Economic Model: rational, informed, self-interested individuals; profit-maximizing firms operating in perfectly competitive markets; with zero transactions costs (including perfect information). All impediments to individuals making mutually beneficial exchanges are assumed away. Looked at from another angle, markets (magically) get the institutions required for efficiency.
  - The logic of Constrained Optimization and Individual Choice
  - Scarcity and Choice
  - Does Pursuit of Individual Self-Interest Promote The Social Good?
- 2. The Basic Economic Decisions Involving Economic Coordination
  - How to Use Available Resources - Production Efficiency
  - What Combinations of Goods and Services to Produce
  - Who Gets the Goods and Services Produced - Distribution
- 3. Basic Concepts in Welfare Economics
  - Concepts of Economic Efficiency and Efficiency Loss
  - Static Efficiency: Exhaustion of all Possibilities to Get Something for Nothing
  - Dynamic Efficiency: Incentives to encourage Innovation and Growth
  - Incentives to reduce costs and develop new goods and services and new ways of doing things [vs traditional societies where individuals may incur social cost (peer disapproval) for trying to reduce costs or introduce new ways of performing economic activities of production, exchange, and consumption]
- 4. Economic Analysis of Taxes: taxes keep individuals from making exchanges that would be mutually beneficial
  - Consumer Surplus and Producer Rents
- 5. Efficiency vs Fairness (Distribution, equality)
- 6. Equity, or Equality, vs Efficiency: Independent or Interdependent - Incentive effects and Property Rights Enforcement Costs
- 7. Redistribution and Social Insurance: See Rawls.
- 8. Use of Demand and Supply Diagram to Provide Money Measures of Utility, Costs, and Efficiency Losses
- 9. Economics of Cooperation and Coordination
  - The Invisible Hand

- Conflict vs Cooperation
10. Information Economics
  11. Transactions Costs and Institutions

## **PART 2:    **MARKETS AND SOCIETY, AND THE ROLE OF MARKET PRICES****

### **Sept. 10    THE ECONOMIC ROLE OF MARKETS AND EXCHANGE**

*"It is the great multiplication of the productions of all the different arts, in consequence of the division of labour, which occasions, in a well-governed society, that universal opulence which extends itself to the lowest ranks of the people." (Adam Smith, WN p11)*

1.    What do Markets do? Markets facilitate exchange of goods and services among individuals and organizations.
2.    Individual Decision Making and Group Coordination  
      Rational Self-Interested Decision Making  
      How a Market Based Economy Answers Basic Economic Questions:  
      What will be produced?; How will it be produced?; and Who will get to consume the goods and services produced?
3.    Market Prices  
      Provide Information  
      As Signals
4.    The Concept of Economic Efficiency
5.    The Central Role of Individual Incentives

### **WHAT ARE THE CAUSES OF MARKET FAILURES?**

*"There are subtle but important differences between the allocationist-maximization and the catallactic-coordination paradigm in terms of the implications for normative evaluation of institutions. [Note: Catallactic, pertaining to exchange; catalactics (n.), study of commercial exchange; thus, catallactic approach focus on individual exchange, the theory of exchange] In particular the evaluation of the market order may depend critically on which of these partially conflicting paradigms remains dominant in ones stylized vision. To the allocationist the market is efficient if it works. His test of the market becomes the comparison with the abstract ideal defined in his logic. To the catallactist the market coordinates the separate activities of self-seeking persons without the necessity of detailed political direction. The test of the market is the comparison with its institutional alternative, politicized decision making." (James Buchanan, Nobel Address, 1987)*

1.    What exactly do we mean by "market failure"? One view is market failure is when markets fail to achieve economic efficiency - an inefficient outcome fails to exploit all possibilities of getting something for nothing, for all mutually beneficial exchanges to occur; or, markets fail to achieve better outcomes than the alternative: political decision making.
2.    J. K. Galbraith believed that individual tastes are endogenous, manipulated by big business, that competitive markets are a myth, and that the real world choice is between private power exercised by giant corporations and the wealthy, or power exercised collectively through democratically elected governments.
3.    Importance of Information (Costly and Asymmetric Information)

- Transactions and Bargaining Costs (and Coase)
- If transactions costs are zero, then private bargaining and exchange will eliminate all efficiency losses - from externalities, monopoly, etc. - All Mutually Beneficial Exchanges will be made.
- Exogenous Tastes and Preferences
- Competitive Markets vs Market Power
- 4. Market Failures: Transactions and Bargaining Costs
- 5. Externalities: Pigouvian vs Coasian Approaches
- The Coase Theorem - Externalities and Monopoly Power
- Public Goods
- 6. The Problem of "The Commons" and Property Rights

**Sept. 17 HOW DO TRANSACTIONS COSTS AND IMPERFECT INFORMATION AFFECT MARKET BEHAVIOR**

- 1. Transactions Costs: Costs of Using Markets and Costs of Using Organizations (including Government Organizations)
- Bargaining Costs and Strategic Behavior
- Commitment Problems and the Limits of Rationality
- Free Rider and Holdout
- 2. Asymmetric Information and Adverse Selection
- Monitoring Costs - Moral Hazard and Principal/Agent Problems
- 3. Examples and Implications of Market Failures in: Financial Markets, Labor Markets, Output Markets

**THE ROLE OF MARKETS IN SOCIETY**

- 1. Efficiency vs Justice
- 2. Fairness and Equality
- 3. Equality of Opportunity vs Equal Outcome
- 4. What Determines Individual Rewards: Endowment, Effort, Chance
- 5. Equality vs Individual Freedom/Liberty
- 6. Does "Commodification" of Things Change Values?

**PART 3: HUMAN NATURE, ECONOMIC BEHAVIOR, AND THE EVOLUTION OF INSTITUTIONS**

**Sept. 24 THEORIES OF EVOLVED HUMAN NATURE AND COOPERATION**

*"Settlement may seem a natural choice to us, but it requires a set of wrenching adjustments for hunter-gatherers. They must learn to live with strangers. They must abandon the freedom to move away from danger or from people they don't get along with. They must yield their firmly egalitarian way of life for a hateful social order of superior and inferior, rife with rules and priests and officials."*  
Before the Dawn: Recovering the Lost History of Our Ancestors, by Nicholas Wade, 2006 (p. 101)

- 1. Alternative Theories of the Nature of Man
- Rational Economic Man
- Adam Smith's View
- *"This division of labour, from which so many advantages are derived, is not originally the effect of any human wisdom,...It is the necessary,...consequence of a certain propensity in human nature ...; the propensity to truck, barter, and exchange one thing for another."* (Adam

Smith, WN p13)

Sociobiology

Freudian View

2. The Limits of Rationality:

\_\_\_ Bounded Rationality: Scarce Information, Cognition, and Time

3. Commitment Problems

\_\_\_ Rationality and Irrationality vs Purposeful

\_\_\_ Group Norms and Individual Behavior

\_\_\_ Education and Socialization of the Young

\_\_\_ Ethics, Morality, and Religion

4. Individual Rationality vs Group Rationality

**Oct. 1 ORIGINS and LIMITS OF COOPERATIVE BEHAVIOR: COMMITMENT, FREE RIDER, and HOLDOUT PROBLEMS**

1. If there are potential gains from exchange/cooperation in a group, would we expect to see cooperation?

2. Free Riding and The Prisoner's Dilemma

3. Is Human Propensity for Cooperative Behavior 'Hardwired'?

\_\_\_ Is Propensity for Cooperation a Beneficial Characteristic for Individual Survival?

\_\_\_ The Problem of Mimicry.

4. If you were a used car salesperson would you want Pinocchio's Nose?

5. Some Thoughts from Sociobiology

\_\_\_ Why do the young appear to take more risks?

\_\_\_ What is the decision making unit?

\_\_\_ Altruism, or disguised self-interest

\_\_\_ The Limits of Rationality

**Oct. 8 EVOLUTION OF ECONOMIC INSTITUTIONS**

*"While institutions frame all human behavior, it is through organizations that people carry out complex social interactions. Understanding human development requires understanding how institutions shape the kind of organizations available for sustainable human cooperation."* (North, Wallis, and Weingast, "A Conceptual Framework for Interpreting Recorded Human History", NBER Working Paper #12795 p 3 ([www.nber.org/papers/w12795](http://www.nber.org/papers/w12795)))

1. Examples of External/Visible Institutions: Constitutions, Legal Structures

2. Organizations: The Role of Organizations in Facilitating Specialization and the Division of Labor

-- Voluntary Organizations: private for profit (firms); private non-profit (Associations, see Tocqueville); and Governmental Organizations

\_\_\_ Voluntary vs Coercive Organizations

3. Constitutional Economics

\_\_\_ Economic Analysis of the Rules of the Game

\_\_\_ Choosing the Constraints

**Oct. 15 Fall Break**

**Oct. 22 ECONOMICS ANALYSIS OF LEGAL INSTITUTIONS AND THE DEVELOPMENT OF PRIVATE PROPERTY RIGHTS**

*"All those in positions of political power, all governments, all kings, and all republican authorities have always looked askance at private property. There is an inherent tendency in all governmental power to recognize no restraints on its operation and to extend the sphere of its dominion as much as possible. ...Private property creates for the individual a sphere in which he is free of the state. It sets limits to the operation of the authoritarian will. It allows other forces to arise side by side with and in opposition to political power. It thus becomes the basis of all those activities that are free from violent interference on the part of the state."* (Ludwig von Mises, The Free and Prosperous Commonwealth, pp. 67-75; reprinted in The Market Economy: A Reader, Doti and Lee, p.85.)

1. Economics and Law
  - The Role of Laws in Reducing Transactions Costs and Facilitating Mutually Beneficial Exchanges
  - Property Rights and Incentives
  - Contract Law and Time Inconsistency
  - Torts and Incentives
2. Importance of Adaptability vs Predictability of Legal Rules
  - Common Law vs Statute Law
3. Different Schools of Law and Economics
  - Fairness vs Economic Efficiency
  - Analysis of Power vs The Gains from Trade
  - Chicago School, Public Choice Theory, Institutional
  - Critical Legal Studies vs Economic Approaches
4. Theories of Justice: Utilitarian and Focus on Outcomes vs The Importance of Process and Natural Rights Views

**PART 4: THE ECONOMIC ROLE OF ORGANIZATIONS AND ASSOCIATIONS: PRIVATE (VOLUNTARY) AND GOVERNMENTAL (COERCIVE)**

*"Americans of all ages, all stations in life, and all types of disposition are forever forming associations. There are not only commercial and industrial associations in which all take part, but others of a thousand different types-religious, moral, serious, futile, very general and very limited, immensely large and very minute. Americans combine to give fetes, found seminaries, build churches, distribute books, and send missionaries to the antipodes. Hospitals, prisons, and schools take shape in that way. Finally, if they want to proclaim a truth or propagate some feeling by the encouragement of a great example, they form an association. In every case, at the head of any new undertaking, where in France you would find the government or in England some territorial magnate, in the United States you are sure to find an association."* (p. 513) (Tocqueville, Democracy in America)

**Oct. 29 THE ROLE OF ORGANIZATIONS AND ASSOCIATIONS: (PRIVATE FOR PROFIT AND NON-PROFIT) AND GOVERNMENTAL IN FACILITATING COOPERATION AND IN COORDINATION ECONOMIC ACTIVITY**

1. From the Perspective of the New Institutional Economics:
  - Organizations arise to Reduce/Minimize Transactions Costs
  - The Function of Organizations in Economizing on Costly Information

2. Principal Agent Issues Within & Between Organizations
  - \_\_\_ Imperfect Contracting and Risk Management
  - \_\_\_ Credible Commitments and Reciprocity
  - \_\_\_ Property Rights and Institutional Policies
  - \_\_\_ Property Rights and Incentive to Innovation
3. Economic Theories of Organizational Structure and Individual Behavior in Organizations
  - \_\_\_ Determinants of Organizational Structure
  - \_\_\_ Asset Specificity
  - \_\_\_ Influence Costs - how are organizational strategies and tactics determined?
  - \_\_\_ A basic trade-off between individual incentives and information flow in work groups and in the organization
4. The Importance of Large Private Organizations (esp. the modern corporation) in a Market Economy
5. The Modern Corporation \_\_\_ Use of transfer pricing in multi-division organizations to better achieve common goals
  - \_\_\_ The famous Fisher Body case/example (GM and Fisher Brothers)
6. Public (Government) vs Private Organizations
  - \_\_\_ Government (defn.) Has a monopoly over the legitimate use of coercion.
  - \_\_\_ Coercion and Power: Choice, Artificial limits to choice, ex. Sharecropper has choice between sharecropping for several land owners, but no choice to own land. Key is - are substitutes available at little difference in price?

**Nov. 5 THE ECONOMIC ROLE OF GOVERNMENT AND THE CONTROL OF ECONOMIC ACTIVITY: SOCIAL CHOICE THEORY**

*"Some writers have so confounded society with government, as to leave little or no distinction between them; whereas they are not only different, but have different origins ... Society is in every state a blessing, but Government, even in its best state, is but a necessary evil; in its worst state, an intolerable one."* Thomas Paine

Adam Smith gives as the initial impetus for government, the need to protect property. *"It is only under the shelter of the civil magistrate that the owner of that valuable property, which is acquired by the labour of many years, or perhaps of many successive generations, can sleep a single night in security....The acquisition of valuable and extensive property, therefore, necessarily requires the establishment of civil government."* ( )

1. Response to Market Failures
2. Distribution and Equity; Efficiency vs Equity - a tradeoff?
3. Size and Role of Government in the US
4. International Comparisons
  - \_\_\_ Central Planning and the Soviet Union
  - \_\_\_ Government and Business in the Japanese Economy
  - \_\_\_ The Role of Incentives - China and Rural led Development
  - \_\_\_ Developing Countries: Markets vs Central Planning
  - \_\_\_ Development and Growth: Roles of Physical Capital, Technology, Development of Human Capital, Legal and Governmental Structures
  - \_\_\_ Government: Efficiency, Equity, and Rent Seeking
5. The Debate over Markets vs Central Planning

- Efficiency vs Equity and Pareto Conditions
- Role of Information
- Planning/Coordination and Individual Incentives
- 6. Government as Impartial Referee; as Regulator; as Manipulator (subsidies and taxes); as Producer
- 7. What is the relationship between economic and political freedom? Friedman's view is that free markets promote political freedom because they separate economic power and political power.

**Nov. 12 ECONOMIC THEORIES OF BEHAVIOR IN GOVERNMENTAL ORGANIZATIONS: PUBLIC CHOICE THEORY**

According to Buchanan: "...the two central elements in public choice theories (are) (1) the conceptualization of politics, as exchange, and (2) the model of *Homo economicus*. The second of these elements is shared with social choice theory, which seeks to ground social choices on the values of utility-maximizing individuals. Where social choice theory and public choice theory differ—and dramatically—lies in the first element noted. Social choice theory does not conceptualize politics as complex exchange; rather politics is implicitly or explicitly modeled in the age-old conception that there must exist some unique and hence discoverable "best" result. This element in social choice theory, from Arrow on, stems directly (from) the allocative paradigm in orthodox economics, and the maximization of the social welfare function becomes little more than the extension of the standard efficiency calculus to the aggregative economy.

By contrast, the extension of the catallactic paradigm—the emphasis on the theory of exchange rather than allocation—to politics immediately calls attention to the institutional structure of political decision making." (James M. Buchanan, *Lives of the Laureates* (4<sup>th</sup> ed.), 2004, pp.142-3)

1. Public Choice Theory - Apply Rational Choice Theory to Behavior in Government Organizations
  - Decision Making by Self-interested Individuals Under Institutional Constraints and Incentive Structures
2. Rent Seeking
3. Theories of Bureaucracy
  - Absence of a Bottom Line
  - Crises Management
4. Government Goods: Immediate Benefit and Deferred Recognition of Costs - Insurance example
5. Special Interests
6. Can Voter Surveys Overcome Special Interest Groups?

**PART 5: THE HISTORICAL EXPERIENCE AND CURRENT ISSUES**

**Nov. 19 THE HISTORICAL EXPERIENCE: MARKETS AND GOVERNMENT**

1. Free Rider Problem and The Rise and Decline of Nations
2. The Laffer Curve in History: An Unstable Dynamic?
3. What Types of Institutions and Organizations have Survived?
4. Do Institutions Evolve To Promoting Efficiency and Fairness?
5. The Concept of Social Capital and the Relationship Between Economic Efficiency and Fairness - Are economic outcomes perceived to be generated by a fair process?
6. Economic Development and Fundamental Change
7. Concentrated Power and Economic Change

8. Attitudes of Elites to Fundamental Change

**Nov. 26 Evening Before Thanksgiving** (No Class)

**Dec. 3 INSTITUTIONS AND ECONOMIC DEVELOPMENT AND GROWTH**

1. Institutional Development and the Colonial Legacy
2. Institutional Development in the Transition Economies
3. Institutional Development in Islam vs the West
4. Decentralized Decision Makings
5. Separation of Powers in Government
6. The Role of the Judiciary
7. Separation of Church and State

**Dec. 10 REVIEW OF COURSE**

**Dec. 17 FINAL EXAM (Take-Home)**

ADA Statement:

“The University of Utah seeks to provide equal access to its programs, services and activities for people with disabilities. If you will need accommodations in the class, reasonable prior notice needs to be given to the Center for Disability Services, 162 Union Building, 581-5020 (V/TDD). CDS will work with you and the instructor to make arrangements for accommodations.”

Faculty Responsibilities:

“All students are expected to maintain professional behavior in the classroom setting, according to the Student Code, spelled out in the Student Handbook. Students have specific rights in the classroom as detailed in Article III of the Code. The Code also specifies proscribed conduct (Article XI) that involves cheating on tests, plagiarism, and/or collusion, as well as fraud, theft, etc. Students should read the Code carefully and know they are responsible for the content. According to Faculty Rules and Regulations, it is the faculty responsibility to enforce responsible classroom behaviors, and I will do so, beginning with verbal warnings and progressing to dismissal from the class and a failing grade. Students have the right to appeal such action to the Student Behavior Committee.”