I. Neoclassical way of understanding society
   A. Underlying Assumptions:
      1. This is a world of scarcity and it is the job of the neoclassical model to explain how that scarcity gets allocated
      2. Rational actors
         a. But as long as act in way that is consistent with economic model, model appears to be working regardless of a person’s real motivation
      3. Producers maximize profits
         a. But often appears to be maximizing profits when underlying motivation may be different: maximize market share, avoid bankruptcy
      4. Sellers seek to maximize utility
      5. Sellers seek to maximize the difference between costs and sales revenue
         a. Costs include cost of capital
         b. Normal Profit = Total Revenue – Total Cost = 0
      6. People respond to incentives
      7. Law of Demand
         a. As price goes up, demand decreases
         b. Static view of one point in time
         c. If extra profits, then more will enter and drive price down
            1.) Assuming zero barriers to entry
            2.) Assuming capital moves freely
            3.) Assuming capital available to enter that sector
            4.) Does not look at “path dependency”—where it is impossible for people to move off a given path
      8. Opportunity cost = benefit foregone
         a. Economics is really about how resources are used
         b. Allocative efficiency—resources are allocated in a way that maximizes that size of the pie
            1.) Resources are being used efficiently when they are being used where their value is highest
            2.) Is the Common Law allocatively efficient?
         c. Perfect Resource allocation= Everyone gets normal profit
            1.) Paretian optimality—if by moving to X situation, no one is in a worse off situation, then that move is paretian superior, if no more paretian superior moves, then at paretian optimality
            2.) Caloree Hicks Efficiency—make move if the bread basket of goods and services increases more than others are hurt—benefits outweigh harm
            3.) Each firm selling at equilibrium price
            4.) Each firm “price taker”—taking market price
      9. Transactions are voluntary
   10. Problems:
      a. Gap between supply and demand
         1.) Could have price controls
      b. Social cost of production does not equal private cost of production
         1.) Could have tax
C. Some costs and benefits are not pecuniary

B. Economics as a science
1. theories as tool to understanding world around us
2. New Challenges—as we have tamed physical environment, we have created new externalities, interdependencies that create a human environment unlike anything in past
   a. Harder to build theories for understanding human environment:
      1.) Not tangible
      2.) Not able to control environment with precision necessary to test theories
      3.) Imperfectly able to control environment to get characteristics wanted
      4.) Ideology: Influenced by context, constructs, beliefs, past experience
         a) Understanding is colored, shaped, and conditioned by culture
            i. Part of path dependence
         b) Beliefs shape the institutional framework of society
            i. Scaffolding, to make world more predictable by imposing structure to make world orderly and organized—i.e. law part of this
         c) Structure shapes the organizations which are derived from scaffolding
            i. Rules of the game and incentive structure define what kinds of organizations will arise
            ii. Rules of the game
               (a) Formal rules—organization structure imposed on human interactions—constitutions, laws, regulations, rules
               (b) Informal norms
               (c) enforcement
            d) Organizations then enact policies
            e) Policies can change reality by changing formal rules of the game, which in turn can change the rules of the game
               i. No guarantee that policies will improve welfare b/c imperfect understanding

II. Structure and Change in Economic History
A. Theory
1. Issues
   a. Neoclassical models
      1.) focus on gains from trade ignore transactions costs arising from the specialization and division of labor
      2.) assumes that individual choices when faced with scarcity reflect desires, wants, preferences and carry opportunity costs
         a) assume that individuals prefer more goods and so will devote their efforts towards increasing the capital stock
         i. Size of capital stock determined by:
            (a) Human capital
            (b) Physical capital
            (c) Natural resources
(d) Human capital, physical capital, and natural resources dependent on technology to determine necessary skills, quality of physical capital and what is natural resources

(e) Technology and “invention potential” determined by stock of knowledge

ii. Invest in areas with the highest rate of return
(a) Eventually shifts supply curve, and demand curve will shift back—assuming neoclassical model working

iii. Invest in new technology when the rate of return is higher than expanding the existing capital

iv. Growth of total output and output per capita—product of fraction of income saved and rate of population growth

b) Opportunity costs—what it costs you to do something—cost of alternatives

3.) Problems with neoclassical model
a) Assumes no institutions and perfect markets
b) No information costs, uncertainty, or transaction costs
c) Private and social costs are assumed equal
   i. Private and social costs are not equal b/c we do not have perfectly specified and costlessly enforced property rights
d) No diminishing rates of return
e) Assumes positive return on savings
f) Private and social costs of having children assumed equal
g) Coherence between choices and desired results

b. Task of Economic History
1.) Explain structures and performance of economies over time
a) Performance
   i. Total output
   ii. Distribution of output
   iii. Output per capita
   iv. Amount of inputs determines amount of outputs—are there increasing or diminishing returns

b) Structure
   i. Societal characteristics which determine performance = political, economic, technological, demographic, ideology

c. Explaining Economic Performance over history
1.) Theory of demographic change
2.) Theory of growth of knowledge
3.) Theory of institutions
   a) Theory of property rights
   b) Theory of the state
   c) Theory of ideology
4.) Problem of Change in history
   a) Neoclassical model focuses only on change via prices in market
      i. Assumes frictionless, instantaneous changes
         (a) I.e. resources will shift around until rates of return the same
b) Fundamentals to understanding change
   i. Must understand structure to understand performance
   ii. Not all changes happen as neoclassical economies imply

c) Free Rider Problem
   i. Neoclassical economies can not explain changes where
   self-interest is not a motivating factor and can not explain why
   people follow rules

2. Structure of Economics
   a. Non-economic institutions interact with the economic (production and
   exchange) institutions
      1.) Change in both is the result of changed perceptions resulting from
      values and opportunities
   b. There have been two major economic revolutions in between have
   population pressure which is sometimes relieved by changing economic
   institutions and sometimes by psychological/social pressures
   c. What has determined rate and direction of innovation
      1.) Gap between private and social returns b/c of problems with
      specifying property rights
      2.) Technological development interrelated
      3.) Diminishing returns unless the stock of knowledge is expanded
      4.) Stocks of knowledge and technology set upper limits but do not
      determine how successful people are within those bounds
   a) Political and economic institutions
      i. Common traits
         (a) Rules and regulations constraining behavior
         (b) Procedures for enforcement
         (c) Moral and ethical behavioral norms
            (1) Compliance costs are reduced by enhancing individual
            restraint
      ii. How does law help economic growth
         (a) Enforce contracts, lower transaction costs, consistency
         stability, make it more likely people will use market by
         providing uniform norms and expectations
         (b) Define property rights—define incentives
            (1) Costs in defining property rights
            (2) Easier to measure = lower transaction costs
         (c) Key is legitimacy of insitutiona
   b) Forms of cooperation, competition, and enforcing rules at heart of
   determining incentives and distribution of wealth in society
      i. To understand this structure need theory of state and theory
      of property rights
         (a) Theory of property rights accounts of organization forms
         that lower transaction costs and organize exchange

3. Neoclassical Theory of the State
   a. What is a state
      1.) Organization whose boundaries are determined by the power to tax
2.) Key is comparative advantage in violence because it gives the state the power to specify and enforce property rights

b. How to explain state
   1.) Contract
   2.) Predatory or exploitation—state as wealth extractor
   3.) Not inconsistent—look at the distribution of violence potential
      a) Equal = contract
      b) Unequal = wealth extractor

c. Objectives of theory of the state
   1.) Trying to explain tendency of states to produce inefficient property rights
   2.) Inherent instability of all states
      a) Stability of state = enough people acting as free-rider, well-specified norms

d. State with single wealth-maximizing Rule
   1.) Trade services for revenue
      a) State specifies rules of the game
         i. Specify rules of competition and cooperation to provide structure of property rights
         ii. Decrease transaction costs to maximize outputs
         iii. Tension between maximizing ruler’s own wealth and efficient system of reduced transaction costs
         iv. Delegation of power to agents means the need to constrain those agents
         v. Different services have different supply curves
   2.) State acts like monopolist and grants only those property rights that maximize state revenue
      a) Monitor and measure outputs and inputs of each part of economy to maximize monopoly rents
   3.) State is constrained by opportunity costs of constituents
      a) Opportunity costs determine bargaining costs, allocation of services
   4.) Inefficient property rights arise from
      a) Competitive constraints
      b) Transaction costs constraints
      c) Property rights that would maximize rents to ruler is in conflict with those producing economic growth
   5.) Both growth and no growth are destabilizing to economy
      a) Stagnant states can survive as long as no change in opportunity costs or strength of rivals
         i. Changes in prices that improves bargaining power can lead to alteration of the rules
         ii. Adjustment happens when private returns exceed private costs
         iii. Problem: how to explain change when returns don’t outweigh costs
(a) Under neoclassical theory
   (1) Freerider problem accounts for stability
   (2) Rulers would always be the innovators
   (3) Revolutions would always be palace revolutions or by competing ruler
   (4) Rules for succession will minimize disruptive change

e. Key is legitimacy of state
   1.) Institutions have to fit with country’s culture society’s beliefs and norms and expectations
      a) I.e. legitimacy of judiciary tied to impartiality
      b) Congress changes norms and expectations
      c) → Hayek—courts should not legislate

4. Framework for analyzing Economic organization in history
   a. Account for economic organization with theory of state and theory of transaction costs
   b. Economic organization must specify and enforce terms of exchange
      1.) Choice of form depends on the amount of resources required for X output
         a) Costs of market price system
            i. Measurement costs
            ii. Enforcement costs
            iii. Costs of imperfect measurement
         b) Costs of hierarchal system:
            i. Costs of measuring performance
            ii. Costs of imperfect measurement
         c) Even simple transactions carry costs
            i. Hard to specify exactly what you want
               (a) Divergence between private and social costs: some valued characteristics are not measured
               (b) Where costs of measurement are too high, have common property
               (c) Organized market reduces information costs
               (d) State can reduce transaction costs through law and enforcement
            ii. Constrained by repeated dealings
            iii. Rely on property rights and enforcement system

2.) When does Firm replaces Market?
   a) Firm = exchanges accomplished by authority and direction not the market
      i. Reduces transaction costs
      ii. Increases productivity (economies of scale)
      iii. But need monitoring to take advantage of the benefits
   b) Choose to vertical integrate transactions when the cost of integration are less than the cost of transacting
   c) Two ways to view firm
      i. Nexus of contracts
ii. Authoritarian governance

c. Costs of choosing form of organization
   1.) Compliance costs differ by form
   2.) Costs of measuring increase with increased complexity
   3.) Hard to measure performance
   4.) Costs of contract
   5.) Risks of opportunism in contracting
   6.) More specialization, more division of labor = more costs of measurement

d. Choose hierarchical organization over market when economies of scale, but the higher measurement costs leave the firm vulnerable to opportunism and increase costs of enforcement

e. Not all markets are pricemaking markets

f. Inefficient forms of organization survive where more efficient forms threaten ruler and where the existing forms have a low enforcement cost to the rulers

g. Problems with neoclassical approach
   1.) Neoclassical literature ignores that hierarchal organization predates the market
   2.) When political control is diffuse, harder to predict property rights that will develop
   3.) Incomplete theory—ignores character traits
      a) Measurement costs of constraining behavior so high that need ideology, investment in legitimacy is a necessary party of economic organization

5. Ideology and the Free Rider Problem

a. Problem: neoclassical system assumes both wealth maximizing behavior and hobessian restraint
   1.) Can account for inaction, but can not account for action where no benefit
   2.) Calculation of costs and benefits too limited—does not take into account differences in values, performance, ideologies
      a) Neoclassical economics can not explain society’s investment in legitimacy
   3.) Adam Smith: have to structure game in such a way that seeking one’s own self-interest also benefits society
      a) Key is how institutions and property rights provide incentives
      b) Problem: political system creates rules of the game
         i. Markets work to induce people to act for benefit of all because of competition
         ii. Political system—always have risk of factions

b. How is knowledge acquired
   1.) Primary socialization
   2.) Secondary socialization
   3.) Construct theories
a) Conflicting theories—due in part to information costs of resolving conflict

b) Ideology as an economizing device to simply decision making process

   i. Economics not enough to predict change in ideologies
      (a) No conclusive tests for determining consequences of choices
      (b) People have different world views based on experience and no way to evaluate different views, different locations, occupations
      (c) Changes in prices may alter perceptions of fairness of system
         (1) Alteration in property rights
         (2) Decline in terms of exchange
         (3) Decline in relative income position
         (4) Reduction in information costs

c) Need accumulations of inconsistencies before change

c. Successful ideologies
   1.) Explain how existing structures of property rights and terms of exchange part of larger system and account of past
   2.) Flexible to capture and retain loyalty
   3.) Overcome freerider problem—must convince to act not in a self-maximizing way
      a) Costs of maintainence of order inversely related to perceived legitimacy of system
      b) Altering how game is played changes reality
   4.) Successful counter ideologies explain that injustices are due to current society and that individual action can bring about utopia.

d. Introduction concept of ideology
   1.) Resolves free-rider dilemma, non-market resource allocation, explains secular change
   2.) Economic theory can incorporate ideology and still be scientific
   3.) Ideology plays a major role in political and judicial decision making

6. Structure and Change in Economic History

a. Progress and regression in societies is accounted for by success and failures in organizations

b. Neoclassical theory
   1.) Optimistic
   2.) Rise in prices because of rise in population results in a series of adjustments leading to equilibrium

c. Classical theory
   1.) Pessimistic
   2.) Fixed land and resources mean that a rise in population results in subsistence wages

d. Marxian theory
   1.) Technological innovation spurs change
2.) Incorporates property rights, state, and ideology, but focuses on technological change and ignores population growth
3.) Classes are too large and varied—better to start with individual and look at aggregation by commonality of interest

e. New institutional economics
  1.) No implication that economic organization always efficient
  2.) All organization carries costs of imperfect measurement and enforcement

f. Forces shaping History in Summary
  1.) Population expansion—rapid drawing down of resource base leads to exclusive property rights
  2.) Exclusive communal property rights → increased specialization and division of labor → rise of state to specify, adjudicate and enforce property right
  3.) State’s size and characteristic and resulting economic organization shaped by physical characteristics of the region, resources, military technology
     a) Economic organization impacted by price of labor, land, and transaction costs
  4.) Growing specialization and division of labor lead to diverse constructions of reality
     a) Conflict over distribution of output
     b) Political economic units needed to legitmitize existing distribution and structure of property rights
        i. Costs of ideology related to costs of information and stability of relative prices
  5.) Decline – conflict among states or internal instability

g. Two revolutions
  1.) Agriculture
  2.) Marriage of science and technology
     a) Elastic supply curve of new knowledge, capital intensive technology and need for new economic organization to realize possibility of new technology
     b) Greater specialization increased measurement costs, risk of opportunism, enforcement costs, and ideological diversity

h. What theory lacks
  1.) No theory of demographic change
  2.) No theory of development of military technology
  3.) Model more tenous when move from single ruler to modern pluralist state
  4.) Institutional innovation is a public good
  5.) No positive theory of the sociology of knowledge

B. History
  1. First Economic Revolution
     a. Agriculture resulted in the ability to increase the resource base and consequently accelerated the rate of progress
b. Cause of First Economic Revolution
1.) As hunting and gathering results in diminishing returns due to population pressure and depeletion of resources, incentives change to encourage agriculture
   a) Even when size of workforce below critical point, will allocate more resources to agriculture as the productivity of agriculture rises or the productivity of hunting declines
   b) When given choice, prehistoric man choose one that made him better off
   c) Key: nature of existing property rights
      i. Natural resources as common property results in unconstrained/ineffient use of the resource—incentive failure
      ii. Agriculture = communal property= more efficient property rights—easier to exclude, monitor, constrain with ideology
d) Key: population growth
   i. Population growth static where:
      (a) Fixed resources
      (b) Exclusive communal rights
      (c) System of enforcement
   ii. At first responded to pressures by dividing, migrating, but eventually bands on inside had incentive to regulate hunting and population growth— incentive to develop exclusive communal property use rights
   iii. As natural harvests became less abundant, incentive to cultivate
      (a) Alternatively, find abundance, protect and defend cultivate
   iv. Incentive to domesticate—rewards from modification
e) Key: plasticity of humans—learning to adapt to novel and new problems
2.) Other possible explanations
   a) Climate change
   b) Gradual increase in knowledge of plants and animals
   c) These explanations ignore possibility of population pressure
   d) Population pressure put pressure on resource base and increased competition—but lacks demographic theory

2. Organizational Consequences of the First Economic Revolution
a. Key to differences in organizational structure:
   1.) Violence potential and geographic constraints
b. Trends after first revolution
   1.) Unprecedented population growth
      a) Colonization—due to pop pressure and conflict
      b) Development of exclusive individual property rights and conflicts over land distribution also response to pop pressures
      c) Changes in incentive structure due to population growth can lead both to instability and to economic growth
2.) Gradual transition to agriculture
3.) State emerges
   a) Key role of religion in legitimizing
   b) Role of geography
   c) Role of military technology
   d) Different forms of state
      i. Different structures of law and property rights (i.e. Greece, Egypt, Persia, Rome)
      ii. *Again see problem of factions
   e) Improved organization of state:
      i. Reduced transaction costs
      ii. Increased regional specialization
      iii. Wider markets due to more secure property rights
4.) Technological progress
5.) Trade develops
6.) Urbanization
7.) Variety of economic organizations emerged
8.) Variety of property rights
9.) Significant economic growth
10.) Unequal distribution of income
c. Agriculture requires more complex set of social/economic organization than hunting/gathering
   1.) Needed property rights, decision makers, capital, division of labor, way to distribute output
   2.) Institutions evolved out of communal decision making
      a) Population growth increased costs of communal decision making
      b) Increased population increased incentive to shirk
      c) The need for more coordination leads to the emergence of the state with its rules, orders, and enforcement powers and ability to compete with other states
3. Economic Change and Decline in the Ancient World
   a. All societies eventually experience economic decline either absolute (per capita) or relative
   b. Even without population growth, would have still have conflict over the redistribution of wealth
   c. What allowed population expansion
      1.) Supply of land and resources that could be used for agriculture
      2.) Increased productivity
   d. Decline as consequence of population growth and diminishing resources
      1.) Increased risk of military conflict
      2.) Increased costs to state
         a) Taxes and confiscations alter property rights so that individuals have a reduced incentive to be productive
         b) Growing tension leads to redistribution of wealth and property rights
   e. Two causes of decline
1.) Barbarians at gate
2.) Decay from within

f. Model of Change in ancient world
1.) Active agents of agent are individuals with direct interest in altering system
2.) Long-term stability of monolithic structure made possible by little chance for challenge, economies of scale
   a) Unequal distribution income distribution kept peasants at very low level of well-being, reducing population growth
3.) Population growth induced change by impacting scarcity of land and relative prices
   a) As price of land increased, had increased pressure for individual property rights
4.) Population pressures lead to migrations, conquests, war
5.) Change by conquest and revolution instigated by rulers and their agents
   a) Used incentives to incite mobs
6.) Growth and decline of slavery as its profitability changed
7.) Centers of economic activity changed
   a) War
   b) Chaos
   c) Lack of secure property rights
   d) Changes in tariffs/taxes/trade barriers
   e) Most common reason: technological diffusion and changing prices
8.) Tensions between rulers and agents
9.) Problem of succession led to political instability
10.) Explanation of stability and change must also consider ideology
    a) Stability reinforced by indentifying ruler with god
    b) Population pressures and struggles for control of wealth redistribution do not account of struggle of jews, Christians, et al to maintain their identity
    c) Agents of change also included religious figures
    d) Actions based not only on material incentives but also ideological conviction

g. Decline of roman empire—rise of apathy, disincentive to economic activity by increased taxation, increased desire for local autonomy as incentives to be romans declined, trade declined

4. Rise and Decline of Feudalism
   a. Importance of Church as carrier of cultural hertitage
      1.) Like state with ruler and bureaucracy
      2.) But not only sold protection, also selling salvation
   b. Small climate changes produce big changes in agricultural output
   c. Gradually emergence of feudalism
      1.) Decentralized political organization
      2.) Hierarchtal fiscal obligations
a) Transactions costs of trading labor for services of lord less than market
b) Lord constrained by scarcity of labor
c) Changing transaction and opportunity costs led to gradual demise
   i. Lower transaction costs increased production of non-agricultural goods
   ii. When labor was scarce, workers had more bargaining power
d) Gradually land became more scarce than labor
   i. Rise of exclusive ownership, ability to transfer, right to restrict access, ability to alienate land
e) Policing costs gradually transferred from individual to state—reduced transaction costs
3.) Manorial economic structure—self-sufficiency
4.) Keys: population change, warfare
   a) Population increases led to colonization and increasing incentive to trade
      i. Property rights tied to guilds
   b) Changes in military technology changed the nature of warfare, scale of warfare, increased the amount of resources necessary for competition
      i. Analogous to when have many small firms in industry and then economies of scale result in change to smaller number of big firms and periods of collusion and competition
      ii. With states, ability to tax, not just size key
         (a) Problems: free rider effect, foreign trade easier to measure, exchange property rights for revenues
         (b) Bargained with representative bodies to get control over taxes. Bargaining power influenced by
             (1) Potential gains to constituents
             (2) Rivals
             (3) Structure of economy
      iii. Shifted from decentralized to centralized political units
d) Gradual increase in economic activity and increase in trade output
e) Decline of feudalism—famine, plague, warfare, gradually replaced by larger political units
5. Structure and Change in Early Modern Europe
   a. Marked by:
      1.) exploration,
         a) colonization influenced by the institutions, property rights of the “mother” country and by patterns of trade and flow of productive factors
      2.) exploitation,
      3.) trade,
      4.) settlement
      5.) causing a widening of the market,
a) gradual movement from personal to impersonal exchange
   i. repeated dealings of small scale producers carries low
      transaction costs, but no economies of scale
   ii. trading with people you don’t know—no longer pays to
       cooperate—need institutions to make it worthwhile to
       cooperate
       (a) need political system that will enforce property rights

6.) increased chance for profit

7.) pressure for structural change to realize new opportunities

8.) structural transformation leading to economic growth

b. Different growth rates in different countries
   1.) explained by different nature of property rights
      a) key is how expanded the state’s right to tax
   2.) France—traded monopolies for $, coupled with the regional nature of
      the French economy meant that France lost gains from growing market
   3.) Spain—trade and commerce declined due to monopolies, high
      taxation, and confiscation and inefficient property rights
   4.) Dutch—more efficient property rights enacted by rep. Body that
      favored growth. Expansion of trade reduced costs because of
      economies of scale and led to more efficiency.
   5.) England—less risk of invasion, internal competition for the crown,
      dependent on export of staples that were easy to measure mean little
      incentive to grant crown authority to determine property rights.
      a) Reduced transaction costs from establishment of private property
         rights and competition in trade—trade between those who had
         wealth in return for more control over politics

6.) Rise of Representative Government
   a) Trade income for political right

6. Industrial Revolution Reconsidered
   a. Changes
      1.) Unprecedented population growth
      2.) Increased standard of living
      3.) Agriculture no longer the dominant economic activity—replaced by
         industry and service
         a) Made possible as agriculture productivity increased
      4.) Urbanization
      5.) Continuous technological change
   b. Revolution—really an acceleration in rate of innovation
      1.) More incentive to innovate: better specified property rights,
         organizational changes reducing transaction costs, increasing market
         size
         a) Long process from invention to market to use, technological
            change comes from day-to-day improvement in technology and in
            human skills
         b) Technological change limited by change in stock of knowledge
c) Need private rate of return to approximate social rate of return—property rights
   i. Better property rights—restraints which encouraged productive growth

2.) 2nd Revolution really wedding of science and technology

2.) Market size increasing meant more pressure for a better common law

d) As specialization increased, firms had to deal with increased transaction costs by changing organization—increased monitoring lowered cost of invention

e) Needed new ideology

7. Second Economic Revolution

a. Revolution =
   1.) change in productive potential because basic change in stock of knowledge and
   2.) basic changes in organization to realize productive potential

b. Both economic revolutions allowed continued population growth

c. How Second Economic Revolution Developed
   1.) Development of scientific disciplines
      a) No longer just discovering things by trial and error—learning underlying reasons for something
      2.) Scientists and inventors exchanged information because aware of high returns if they made more expenditures in research
   3.) Evolution of property rights raised the private rates of return closer to the social rate of return
      a) Institutional changes happening well before industrial revolution
   4.) Technological breakthroughs
      a) New tech to replace man’s hands
      b) New energy sources
      c) Ability to transform matter
      d) Needed large volume production to realize gains—indivisibilities in production process and large fixed-capital investment
      i. Needed coordination and an organizational structure to specify rules and compliance procedures to specify compliance procedures, lowering transactions costs of new technology
      ii. Transaction costs problems:
         (a) How to measure
         (b) How to monitor inputs
         (c) Quality control
         (d) Labor discipline
         (e) Bureaucracy
         (f) Problems from team production
            (1) Measurement costs
            (2) Increased risk of shirking
            (3) Increased opportunism
         (g) Externalities
      iii. Needed more new technology to reduce transaction costs
iv. Also dealt with by providing: warranties, grading, labeling to assure customers of quality

v. Revolution has changed in last 20 years
   (a) Giant Factories not always reality, not all production standardized
       (1) Variation in demand means that some producers must tailor output to meet demand
       (2) Large quantities don’t always pay
   (b) Effect of internet and computer—lower information costs
   (c) Can move capital very quickly—destabilizing capital markets

5.) Backlash against market
   i. control of state passed to those who favored revising market system
      (a) alienation
         (1) problems with social cohesion
         (2) alienation dealt with in U.S. by growth of bread and butter unions—groups felt like they had a stake in the system.
      (b) special interest groups
      (c) both alienation and special interest group theories lack theory of state and theory of ideology
         (1) needed new ideology to legitimate new rules of the game
         (2) impersonal exchange led to many differing perceptions of reality, different ideologies, fewer personal ties, needed formal contracts, but also had more incentive to act in self-maximizing way → antagonistic exchange relationships
      (d) need explanation for how the free rider problem was overcome to allow new groups to gain control =
         (1) change in ideological perspective of workers
         (2) interest groups had increased incentive to try to control instability of market
   ii. neoclassical economics fails to come to grips with ideological consequences of second revolution
   iii. Marxian focus on structural change and tension between production and property rights but ignores intra-class conflict and saw alienation as problem of capitalism not second revolution
   iv. Polyani—problem impersonal labor and land market, gold standard
      (a) Earlier property right have been replaced with political struggle to redistribute income and wealth
v. Still facing problem: How to structure the game so that the
Market result’s in Adam Smith’s ideal—people pursuing make
own self-interest get socially beneficial results
(a) Incentives do not spur people to create things that make
society as a whole better off
(b) Instead, incentive to take advantage of others

d. Keys of Second Revolution:
1.) Global market now—interdependent
   a) But playing field not level and trade not free
2.) Rise in externality
3.) Destabilizing family
4.) Social consequences

8. Structure and Change in the American Economy 1789-1914
a. Second Revolution lead to rise in role of government
1.) Increase in government income
2.) Increase in number of groups participating in government
3.) Change in constraints of economic structure
4.) Change in locus of restraints
b. America
1.) Deep distrust of state
2.) Wanted to ensure that factions did not get monopoly and the systems
   of checks and balances was designed to remove incentives to use
   political system to redistribute wealth
3.) Growth of legal system using neoclassical theory’s efficiency criteria
   a) Efficiency criteria misses some costs and benefits—only got those
      measured by GNP
      i. Is economic growth always good?
         (a) Problem—hard to measure externalities, well-being
         (b) Per capita growth more important when talking about truly
             impoverished nations
      b) Per capita income increased
      c) Inequality of distribution increased
4.) Gradual shift to greater government control—growing awareness of
   limited supply of land, resources,
   a) Munn v. Illinois—government could regulate private property
   b) Laid foundation for move away from frame’s system
   c) Executive branch departments became lobbying bodies for special
      interest groups
      i. Firms supported regulation
         (a) Wanted government to bear costs of inspection
         (b) Allowed decrease in competition
         (c) Increase demand
      ii. Reduced costs of utilizing political system to alter property
          rights
   d) Key: Judiciary + special interest groups
5.) Rise of Taxing power
6.) When does government have advantage:
   a) Public goods
   b) Information is asymmetric
   c) Externalities need dealing with
   d) Specifying and enforcing property rights

7.) American success story really story of incentives
   c. Ideological changes contributed to rise of special interest groups
      1.) 2nd rev brought gains from opportunism and limiting competition
         a) voluntary agreement—too risky, government more effective
         b) diversity of workforce raised costs of widespread political activity
         c) need ideology to explain changes enacted—interest groups used ideological changes

d. created more interdependent world
   1.) risk: destruction of family as mobility increases, government provides for more needs, leads to social problems as struggle to find viable substitute

C. Theory and History
   1. A Theory of Institutional Change and the Economic History of the Western world
      a. Institutions provide a framework for cooperative and competitive relationships of society and economy by constraining choice sets, filtering between individuals and capital stock and between capital stock and output
         1.) Institutions = rules, compliance procedures, and norms designed to constrain behavior of agents to maximize wealth of principles
         2.) Constitutional rules—fundamental rules specifying basic structure of property rights
         3.) Operating rules—statutes, common law, contracts, specify terms of exchange within constitutational rules
         4.) Normative behavioral rules—codes of behavior aimed at legitimizing constitutional and operating rules
         5.) Rules relative to cost of enforcement, costs of measurement
         6.) Transaction costs
            a) Uncertainty
            b) Costs of compliance
            c) Costs of detecting violations, enforcement
            d) Measurement
            e) Information costs
            f) Agency costs
            g) Opportunism
            h) Shirking
         7.) In personalized exchanges don’t need formal rules and compliance procedures because constrained by repeated dealings
         8.) When diverse ideologies develop, have to spend more to legitimize institutions
         9.) Stability of institutions due to norms and constitutional rules
10.) Capital stock changes because of population changes and knowledge base changes
   a) Changes in capital stock results in changes in institutions
      i. Changing prices, change bargaining positions
      ii. Changing military technology changes maximum size of the state and bargaining positions
      iii. Changing ideologies = changes in perceptions of fairness and changes in perceptions of fairnessness of relationships— enforcement costs change
   b. Structure= institutional frameworks
      1.) Political and economic framework made of institutions trying to maximize utility of rulers by specifying underlying structure of property rights and control over coercion
         a) Terms of exchange between rulers and constituents —determined by costs of compliance and violence potential
         b) Size of states—costs of agency and military technology, ideology
      2.) State – framework to adjudicate and enforce rules and codes of behavior
         a) State determines forms of economic organization by determining contractforms
         b) Reduce compliance costs, transaction costs
         c) Forms of voluntary organization all depend on: relative prices, stock of technology, costs of enforcing alternative forms of economic organization
            i. Market vs. hierarchtal forms—enforcement costs, measurement costs
   c. Change – ways institutions are created modified or destroyed over time
      1.) First revolution—state, political constraints for economic order, expansion of specialization and division of labor beyond primative requirements
         a) Personalized exchange, m and limited by stock of technology
         b) Increasing size of state led to increasing agency costs and rules and compliance procedures
      2.) Second Revolution
         a) Unparrelled living standards
         b) Tension between costs and gains of specialization
      3.) Economic historic as evolution of constraints

III. Hayek
   A. Role of the law
      1. chief instrument of change should be legislation
      2. Role of judiciary to apply principles—provides stability
         a. Will make other rules conform to principles
         b. Change only when get new general principles
            1.) Risks of change—justification of economic necessity often baseless
            2.) Principles that guide law come from outside the law and are only benefical if they accurately reflect reality
a) Social institutions are shaped by ideologies as people treat abstract ideas as truths and presumptions not theories
b) May not foresee consequences of ideas

B. Evolution of Law
1. Laws of nature and laws of conduct originally thought of as being independent of free-will
2. now, assumption that all law derives from legislature
3. Possible explanation for evolution of law:
   a. Had abstract rules to order group activities long before man could express them
      1.) Abstraction of rules is difficult to articulate
      2.) Early articulation was not inventing new rules but attempting to articulate existing ones
      3.) Rulers enforce existing rules and give commands to achieve a purpose
         a) The gradual process of articulation still operates within the framework of unarticulated rules
         b) New rules seem implicit because necessary to preserve existing rules
      4.) Gradually get norms—what ought to take place when have choice whether or not to obey them
   b. Early laws
      1.) Trade and exchange created need for universal rules of conduct
      2.) Believed that could discover law
      3.) Rise of power of legislation—power to create new rules of conduct along with power to direct government
      4.) English common law—freedom of courts—legislature alone did not make law
   c. Evolution of law—rules which arise out of custom and precedent (i.e. judicial rules) more abstract that rules of ruler
      1.) Judge trying to determine what expectations of parties should have been
      2.) Did the conduct conform to recognized rules
      3.) Legislation different because applies uniformly
         a) But can use legislation to correct common law articulations of general principles
         b) Judicial development is gradual and may not be able to adapt to new circumstances—not function of judiciary to overturn precedent
      4.) Problem with belief that legislation is the sole source of law
         a. Erroneous assumption of supreme legislator with unlimited power and that all acts of supreme legislator are law and that is only law
         b. Power of legislature rests of opinion of attributes of law

IV. Coase—Problem of Social Cost
A.