Chapter 5 #1) Define transaction costs. Under what circumstances are market transaction costs low? Under what circumstances are market transaction costs high? Provide examples.
Transaction Costs are the costs of making and enforcing the exchange of entitlements. The conditions that foster high-market transaction costs:

a. Negotiation costs arising from the combination of bilateral monopoly with many participants on both sides.
b. The cost of monitoring and enforcing the agreement, as well as the cost incurred when one or both parties try to renege on the agreement.

There are low-transaction costs when

a. There are well-established prices for goods considered
b. There is no information asymmetry
c. A unanimous agreement is not required
d. Monitoring is not required, especially when a low-cost alternative is in-place.

Chapter 5 #2) When do monopoly holdouts occur? Explain why monopoly holdouts create high market transaction costs. The monopoly holdout problem arises whenever unanimous agreement is needed among several participants. High transaction costs arises from the fact that each owner tries to be a monopoly holdout and try to extract the surplus for herself.

Chapter 5 #3) When do free-riders arise? Explain why free riders create high market transaction costs. Free-riders arise when one or more parties are able to enjoy the benefits of an activity paid for by other parties. This is a high transaction costs given that valuation of each individual are not known and is difficult to find out.

Chapter 5 #4) Suppose that in bidding for a ticket, Arnold has the highest bid. Suppose instead that the ticket was given to Arnold. Explain why Hillary would be unlikely to buy the ticket from Arnold. Suppose that the ticket was given to Hillary instead. Explain why it is *likely* that Arnold would buy the ticket from Hillary. Explain why Hillary *might not* sell the ticket to Arnold in this last case. Since Arnold has the highest bid, we know that he has the highest valuation for the good. Therefore, if he originally gets the ticket, no one will be able to purchase it since everyone else value the ticket less than he does. If Hillary gets it, Arnold can purchase it from her since he values it more than she does. Therefore, he can pay her a bit more than she values it but at most as much as he values the ticket. This mutually beneficial trade may not occur, however, as high transaction costs could be present.

Chapter 6 #1) State the Coase theorem. Provide an intuitive explanation. Illustrate using the rancher-farmer example provided by Coase. The Coase theorem states that if

(i) there are zero transaction costs and
(ii) mutually beneficial trades are always made when transaction costs are low

then, whatever the initial assignment of entitlements,

a) the outcome will be efficient, and
b) the outcome will be the same when the changes in the distribution of wealth do not affect consumption patterns

As for the rancher-farmer example, if transaction costs are low, Pareto-improving exchanges are made, and consumption patterns are not altered, then it makes no difference on the amount of damage made by cows if ranchers have the right to trample the farmers' fields or farmers have the right to not have ranchers' cows trample the farmers' fields. The outcome will be based on whether it is more efficient for the cows to trample over the corn or not while the actions are based on the initial assignment of rights. The four scenarios are as follows:

1. If he rancher has the right to damage the farmer's crops, but it is more efficient to not have cows trample the farmer's corn, then the farmer will pay (bribe) the rancher to keep his cows off the farmer's land.

2. If the farmer has the right to no damage and it is more efficient to not have cows trample the farmer's corn, the rancher cannot bribe the farmer and so, the rancher will pay for the fence to keep his cows from trampling the farmer's corn.

3. If the farmer has the right to no damage and it is more efficient for the rancher's cows to trample the farmer's crops, then the rancher will pay the farmer a bit more than the damages the farmer suffers. In this way, the rancher's benefits is higher than if he builds a fence.

4. If the rancher has the right to damage the farmer's property and it is more efficient for him to do so (cost to farmer is less than cost of building the fence), then the farmer cannot bribe the rancher to build a fence, thereby no fence will be built and the rancher's cows will trample over the farmer's corn.

Chapter 6 #2) Provide an example demonstrating that the allocation of entitlements make a difference when there are high transaction costs. Given high transaction costs, the initial allocation of entitlements will tend to be the final allocation of rights, and hence not all allocations will lead to wealth maximizing outcomes. Even when transactions are not very costly, the still should be economized on. Movement from one allocation of rights to the efficient allocation of rights involves transaction costs. Therefore, the initial allocation of entitlements should be the wealth-maximizing allocation to save on such costs.

An example of a high transaction cost situation is prevention of trespassing on land and on air. If airlines have to ask permission from all landowners for use of the air above, that would impose high transaction costs since every landowner would try to extort all the value for himself by being the monopoly holdout since unanimous agreement is required. Hence, if landowners were given the property right to not have trespassing, there would be no flights.

<u>Chapter 6 #3) Do people always trade to mutual advantage?</u> No. Each person hopes to capture all the surplus from the trade. But the seller does not know what the highest price the buyer is willing to pay and the buyer does not know the lowest price at which the seller is willing to sell the item. In the absence of this knowledge, the buyer may overestimate the true value to the seller and the seller may overestimate the true value to the buyer. Each will think that the other is bluffing and no trade will take place. Even walking away will not be sufficient since the other side may think that the person will turn around or come back the next day (and when the next day arrives without the other person turning around, the expectation may be that the person will come back in two days, etc).