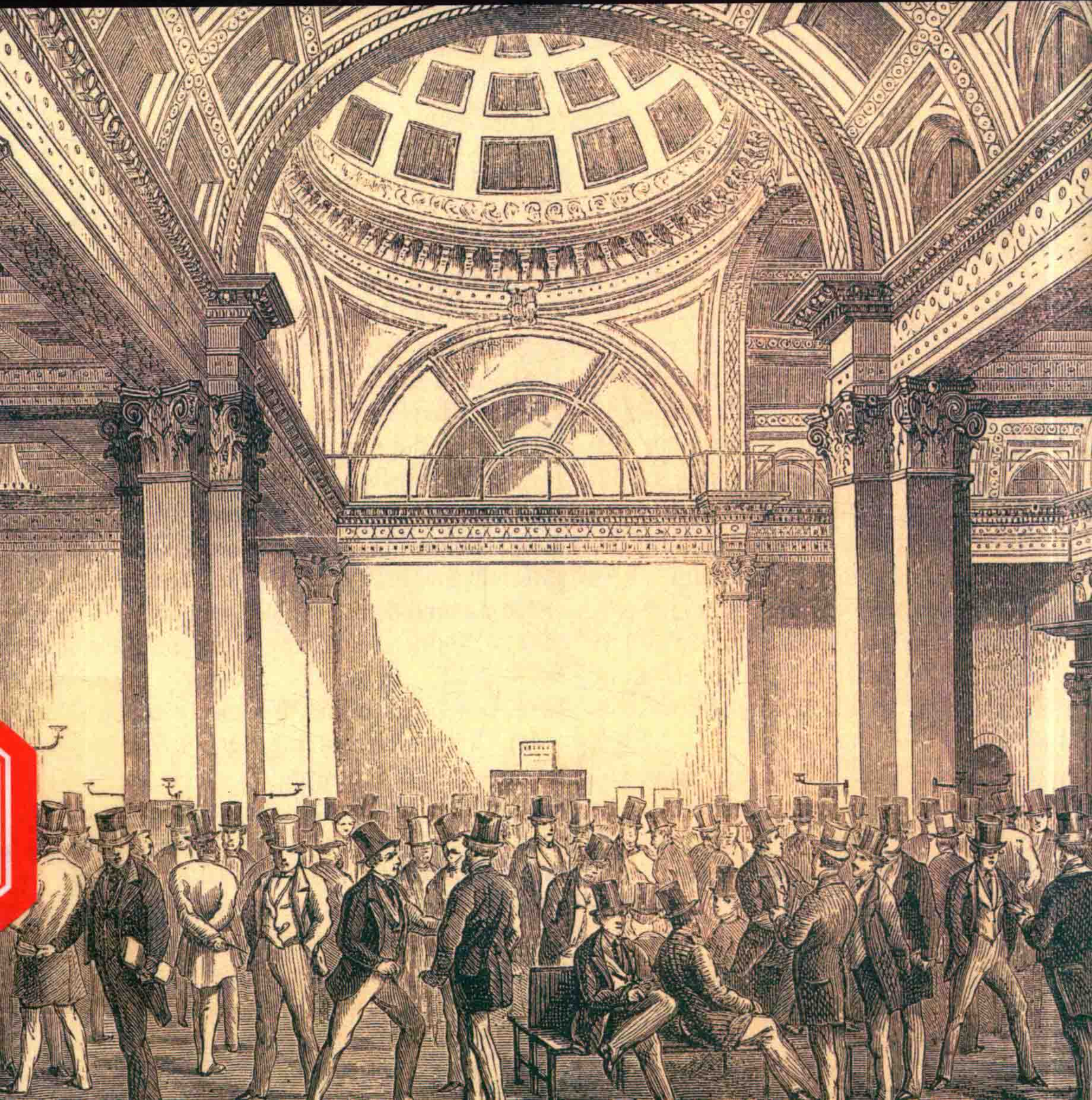
PRIVATE GOVERNANCE

Creating Order in Economic and Social Life

EDWARD PETER STRINGHAM



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Private Governance

To legal centralists of all parties.

FOREWORD

Edward Peter Stringham's *Private Governance: Creating Order in Economic and Social Life* is wonderfully written and chock full of compelling case studies of precisely how individuals and communities achieve governance without turning to government. Stringham provides examples that cross time and cultures, from the origins of financial markets to the complicated transactions that define our modern global economy.

Traditional political economists believe that without a strong state authority, private actors will prey upon those weaker than themselves. In so doing, traditional political economists commit errors of both overpessimism and overoptimism. The standard analysis is overly pessimistic about the ability of individuals and communities to find rules that enable them to live better together and to realize the social gains from cooperation rather than devolve into social conflict without the establishment of a coercive state authority. But the standard analysis is also overly optimistic about the state's ability to establish binding constraints on itself so that societies are not just trading off the threat of private predation for public predation.

History is filled with examples of aggressive and oppressive public predation, so this intellectual error of overoptimism is one of the most costly ever committed. The committing of that error was made possible, though, because of the first error, overpessimism, which hides from view, as Stringham puts it, "the unseen beauty that underpins markets." It is in correcting that error that Stringham's major contribution resides.

Building on the insights of James Buchanan and his "Economic Theory of Clubs," Stringham demonstrates in ways beyond the theoretical imagination of even Buchanan how far one can stretch the basic argument for private governance. But theoretical imagining, let alone normative pontificating, is not what Stringham is content to do. Instead, he demonstrates in one example after another that individuals are able to come together, devise rules, and agree to mechanisms of enforcement in ways that transform situations of potential conflict into opportunities of mutually beneficial and reinforcing cooperation.

His narrative introduces the reader to something that is absolutely beautiful: the amazing capacity of diverse individuals to realize peaceful cooperation and productive specialization without the explicit threat of violence by a geographic monopoly on coercion. Readers will see this beautiful cooperation in Amsterdam and London as the institutions of modern finance are born, as well as in advanced technology such as PayPal and in the rise of private arbitration. Along the way, Stringham also shows how a state monopoly on governance distorts cooperative tendencies and introduces social cleavages and conflicts where otherwise they would not appear. In short, public government can crowd out effective private governance.

Along these lines, Stringham's application of his theory of private governance to the financial crisis of 2008 is a most welcomed perspective on the idea that Wall Street requires government control and a helping hand to function properly. Stringham argues that private governance mechanisms were already in place and working before the crisis, but government regulations and bailouts distorted those mechanisms and prevented them from functioning as they would have in the absence of the state's coercive interference.

Throughout this book, Stringham successfully marries the best ideas from property rights economics, law and economics, public choice economics, and Austrian economics to form his own private-governance perspective. He constantly tests this perspective through examinations of how individuals and groups find myriad ways to police both themselves and other participants for the activity under examination.

Stringham tells an inspiring story, but not a utopian one. It does not require any change in human nature. He treats individuals as they are—sometimes sinners, sometimes saints, sometimes smart, other times not so smart—documenting the ways they muddle through and figure out that cooperating is better than not cooperating to realize the gains from trade and innovation.

Edward Peter Stringham has written an inspiring book about the unseen beauty of the cooperative abilities of mankind. All social thinkers should take notice of how diverse individuals have developed a variety of private institutional arrangements that enable them to live better together and to realize the great gains from peaceful cooperation and productive specialization. This "marvel of the market" is indeed a thing of beauty.

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Private Governance

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PART ONE

Why Private Governance?

CHAPTER 1

Introduction

It's the year 1762, and you are a London stockbroker in the narrow Exchange Alley between Cornhill and Lombard Streets. You haven't been doing too well recently, but share prices for this one long purchase you made have been going up. Everything is looking perfect. But at settlement time you notice your trading counterpart in an expensive-looking new coat, and he tells you he's not going to deliver your shares. He says, "What are you going to do? Sue me? Did you forget that courts refuse to enforce these contracts?" In eighteenth-century London a defaulting broker *could* have been common, but such a predicament was *not* in fact common. Without the ability to rely on external courts, brokers transformed coffeehouses into private clubs that created and enforced rules. Each club aimed to admit only reputable brokers, and those who broke the rules would be kicked out and labeled a "lame duck." The private club known as Jonathan's Coffeehouse eventually became the London Stock Exchange, which adopted as its motto "My word is my bond." The rules did not come from government, but from the private sector, from private governance.

In modern times PayPal and eBay and other payment processors and clearinghouses also create order in markets and facilitate exchange. Private governance describes the various forms of private enforcement, self-governance, self-regulation, or informal mechanisms that private individuals, companies, or clubs (as opposed to government)[1] use to create order, facilitate exchange,

1. Here I use the terms *government*, *private*, and *club* according to their dictionary definitions from Merriam-Webster (2013): "Government: the group of people who control and make decisions for a country, state, etc"; "Private: intended for or restricted to the use of a particular person, group, or class"; and "Club: a group of people who meet to participate in an activity." Regulators, police, or courts provided by local, state, or national governments are considered governmental because they make decisions for everyone in a region (regardless of whether people agree), whereas rule makers or enforcers at private colleges or stock exchanges are private and only apply to people who do business in those venues. I discuss the differences more in chapter 3.

and protect property rights. From the world's first stock markets in the seventeenth century, to private policing in the early days of San Francisco, to millions of credit card transactions governed by private rules today, *Private Governance* makes the case that privately produced and enforced rules are more common, effective, and promising than most of us believed. Credit card transactions, electronic commerce, and the world's most sophisticated financial transactions are made possible because of private governance.

The heart of this book is case studies with examples that include the following:

1. My Word Is My Bond. In seventeenth-century Amsterdam and eighteenth-century London, the world's first stock markets were surprisingly complex, with short sales, forward contracts, and options contracts even though none were enforceable in official courts of law. In these markets the forces of reputation acted as an alternative to government enforcement. The most advanced markets the world had ever seen and modern capital markets owe their existence to private governance.
2. The Hidden Law of Online Commerce. Millions of electronic transactions occur every day without a thought. Even though government has difficulty tracking down anonymous fraudsters, transactions are protected by a complex system that manages and prevents fraud before it occurs. The better intermediaries deal with fraud ex ante, the more irrelevant the inefficacy of government law enforcement becomes.
3. Where the Streets Are Policed with Gold. With the California Gold Rush tens of thousands of people moved to San Francisco, but early on government police were entirely absent. Even after they were created, they were considered worse than the private criminals. To deal with the problem of crime, including crime from government, merchants organized a private police force that had a thousand members by 1900 and still patrols San Francisco today. Bundling protection with real estate enables merchants to have a more responsive police force than government.
4. *Compromis* Is Not a Compromise. Alternative dispute resolution (and the *compromis* document agreeing to arbitrate) allows parties wanting third-party adjudication to have cases adjudicated in the manner they want. They get to select the rules, the procedures, and who adjudicates a dispute. Private parties are willing to pay money to hire private judges who are experts and adjudicate disputes as the disputants prefer.
5. Derivatives as Anything but Derivative. Derivative markets are among the most sophisticated and largest markets in the world, with the value of notional contracts outstanding exceeding world GDP multiple times over. Collateralized debt obligations, credit default swaps, and other complex products create new bundles of property rights that are not the creation of government. Although they are wildly misunderstood, and often vilified

for causing crises, these financial instruments work remarkably well at mitigating risk and expanding the scope of markets.

Private Governance describes some of the major mechanisms that private parties use to produce social order and highlights how modern markets would not be possible without them. Analytical narratives weave together history and economics to show readers how private governance works. The hypotheses are: that potential problems such as fraud are pervasive, but so are private solutions; that private governance is a far more common source of order than most people realize, but few people notice it; and that private parties have incentives to devise various mechanisms for eliminating unwanted behavior, and among them the efficacy of nonviolent mechanisms is particularly underappreciated. This book explores some of the different mechanisms, including sorting, reputation, assurance, bonding, and various forms of ex ante risk management, that underpin markets.

The approach of private governance stands in contrast to what Gallanter (1981) and Williamson (1983) labeled legal centralism, the idea that order in the world depends on and is attributable to government law. Legal centralism is widely held among lawyers, lawmakers, and even free-market thinkers who believe that "the protection and enforcement of contracts through courts and civil law is the most crucial need of a peaceful society; without such protection, no civilization could be developed or maintained" (Rand, 1966, p. 299).

Yet, whether one likes or not, often government law enforcement is absent, too costly to use, or unknowledgeable about or uninterested in protecting property rights or contracts. Because government regulators, police, and courts are, to put it in the nicest way possible, "imperfect," private parties have potentially important unmet needs. Such parties can either live with problems or attempt to solve them. What do they do? People can rely on government, or they can devise private solutions. Williamson (1996, p. 121) writes that most researchers ignore "the variety of ways by which individual parties to exchange 'contract out of or away from' the governance structures of the state by devising private orderings." Williamson (2005, p. 16) concludes his Ely Lecture to the American Economic Association by saying, "I submit that our understandings of economic organization and public policy pertinent thereto have been needlessly impoverished by failures to pay heed to the lessons of governance. The economics of governance is an unfinished project whose time has come."

Williamson calls on researchers to study all areas of governance, and this book focuses on, you guessed it, private governance. One of the premises of this book is that just as one should not assume the effectiveness of governmental legal solutions, one should not assume the effectiveness of private legal solutions. Although not legal centralists in the traditional sense, many radical libertarians are legal centralists of a sort who simply substitute private enforcers for government enforcers of law. If a potential problem comes up, the libertarian legal centralist is prone to say, "That would be illegal in my ideal world." Yet even the best private police or courts might not be able to solve a problem in a cost-effective way, so private parties may have to live with certain trade-offs or seek alternative solutions. Instead of relying on legalistic mechanisms to facilitate trade and protect property rights, private parties have created countless private mechanisms to underpin exchange and make markets work.

Although I believe normative discussions of what qualifies as a legitimate market system are necessary and useful, as Kant pointed out, ought statements imply can statements, so one also needs to have economic discussions about how matters can or cannot work.[2] The examples in this book are not hypothetical solutions but rather real-world solutions from private governance. Focusing on actual rather than hypothetical examples eliminates the need to speculate about whether certain problems could be solved. For example, one need not debate whether complex financial transactions can take place without external enforcement (something that Olson [1996] asserts is impossible), if one can observe them taking place for centuries. The examples discussed in this book are tremendously important for creating modern markets, but countless other examples of private governance exist. After some theoretical discussions from the 1970s about private order, economists including Bruce Benson, Robert Ellickson, Avner Greif, Terry Anderson, and P.J. Hill were pioneers in documenting examples, and I now believe the research potential for this topic is nearly limitless.

An implicit assumption in many normative debates is that private solutions cannot be relied upon for complex problems. Can private governance facilitate cooperation in sophisticated transactions, in large groups, in heterogeneous populations, under conditions of anonymity, or across long distances? Or will problems such as free riding and prisoners' dilemmas lead to market failure? All of these are empirical questions whose answers are usually assumed rather than investigated.

Yet mechanisms of private governance are far more ubiquitous and far more powerful than commonly assumed. Mechanisms of private governance work in small and large groups, among friends and strangers, in ancient and modern societies, and for simple and extremely complex transactions. They

2. This book focuses on economics rather than philosophy, but readers interested in philosophical discussions of a privately governed society can read Barnett (1998); Chartier (2013); Casey (2012); Huemer (2013); Long and Machan (2008), Narveson (2008), Rasmussen and Den Uyl (2010); Sanders and Narveson (1996); Skoble (2008) and Watner, Smith, and McElroy (1983). My normative ideals are represented in those works. Economic books about this subject include Anderson and Hill (2004); Benson (1990, 1998); De Jasay (1997); and Friedman ([1973] 1989), and books making rights-based and economic arguments include Hoppe (1989) and Rothbard (1973, 1977, [1982] 1998). For an overview of this literature, see Stringham (2005a, 2007), Powell and Stringham (2009), and Boettke (2005, 2012).

often exist alongside, and in many cases in spite of, government legal efforts, and most of the time they are totally missed. The more that private governance solves problems behind the scenes, the more people overlook it and misattribute order to the state. Milton Friedman, for example, recognizes that private rule enforcement could work, but considers it rare: "I look over history, and outside of perhaps Iceland, where else can you find any historical examples of that kind of a system developing?" (Doherty and Friedman, 1995).[3] After reading this book, I hope Friedman would answer instead that private order is all around us. Private governance is everywhere and responsible for creating order not just in basic markets but also in the world's most sophisticated markets, including futures and advanced derivatives markets. If the success of private governance were limited to the examples in this book, the track record should be rated superb. Yet they are a fraction of what has worked and will work in the future. I hope this research inspires others to document some of the countless mechanisms that have made markets as robust as they are.

Research in private governance not only gives a better understanding of how markets work, but also has many normative implications. Where legal centralists assume that government is the source of order and look to additional rules and regulations to deal with potential problems, the necessity and effectiveness of their solutions are usually unconsidered. According to Spinoza (1670, c. 20), "He who tries to determine everything by law, will foment crime rather than lessen it." In this perspective order comes about privately, and attempting to legislate outcomes can have the opposite effect. Government is often dysfunctional and crowds out private sources of order, or it is simply absent or too costly to use. With so many government officials ignorant of or even outright hostile to markets, how much should one attribute the existence of markets to them? Providers of private governance recognize government is not the solution, so they take the initiative and devise private ones.

Friedrich Hayek used the word *marvel* to describe the price system and its role in coordinating disparate individuals. The mechanisms of private governance are just as marvelous and are responsible for creating order in markets. As Thomas Paine ([1791] 1906, p. 84) writes:

> Great part of that order which reigns among mankind is not the effect of government. It has its origin in the principles of society and the natural constitution of man. It existed prior to government, and would exist if the formality

3. Friedman was asked about societies with fully private enforcement, so I may be misrepresenting his position. Nevertheless, even in societies with government, private governance plays a crucial rule. As Galanter (1981, pp. 19–20) states, "Societies contain a multitude of partially self-regulating spheres or sectors, organized along special, transactional or ethnic-familial lines ranging from primary groups in which relations are direct, immediate and diffuse to settings (e.g., business networks) in which relations are indirect, mediated and specialized."