

PRIVATE GOVERNANCE

◊ *Creating Order in Economic and Social Life* ◊

EDWARD PETER STRINGHAM



Private Governance

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and Social Life*



Edward Peter Stringham

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To legal centralists of all parties.

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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 bail-outs 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.

Peter Boettke
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Private Governance

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 role. 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.”

of government was abolished. The mutual dependence and reciprocal interest which man has upon man, and all the parts of civilised community upon each other, create that great chain of connection which holds it together.

The invisible hand analogy in economics sheds light on underappreciated processes of coordinating behavior, and the study of private governance sheds light on the underappreciated mechanisms that create order. Markets, from soup to nuts, are where they are because of private governance. Yet the more seamless private governance is, the fewer people notice it or appreciate its beauty. Private governance is so often missed, but it makes markets possible.

CHAPTER 2



Beyond the Deus ex Machina Theory of Law

2.1. INTRODUCTION

In Euripides's (408 B.C.) play *Orestes*,¹ the stage is set by describing Orestes's grandfather Atreus, who killed Thyestes's children and feasted on them, and Orestes's father, Agamemnon, who is later murdered. Soon after, Orestes kills his mother and becomes sick from a cruel wasting disease, his mother's blood goading him into frenzied fits. Orestes's sister Electra spends half her life weeping and wailing about her being a maid unwed, unblest with babes, and dragging out a joyless existence as if forever. Orestes's uncle, Menelaus, arrives to look for his wife Helen, whom he suspects has been murdered by Orestes, but Helen's body is nowhere to be found. Menelaus finds Orestes and his friend Pylades with a sword at the throat of Menelaus's daughter, Hermione, and they threaten to kill her and burn the family palace. "Ah me! what can I do?" Menelaus declares. With 95 percent of the play complete (the final 2.5 pages remain in the Coleridge translation), matters are looking pretty grim. But right before the very end Apollo appears from above with Helen, whom he has rescued from death. Apollo announces that Helen is granted immortality in the mansions of Zeus and will be honored with drink-offerings as a goddess forever. Apollo tells Orestes that Orestes will return to Athens and go on trial before the gods, but win his case, marry Hermione, and become ruler of Argos. Apollo takes the blame for forcing Orestes to murder his mother and says he will bring about reconciliation. Apollo says that Menelaus will become ruler of Sparta, and Menelaus wishes Helen well in heaven's happy courts and gives

1. I create this paragraph abridgement almost entirely using exact phrases from the translation by Coleridge (1893).

his blessing to Orestes to marry his daughter. Apollo declares, "Repair each one to the place appointed by me; reconcile all strife." The end.

It might be nice if the world's problems were solved that way, but commentators from Aristotle to Nietzsche argue such writing is questionable.² The *deus ex machina* (god from the machine) plot device is named for Greek plays that used gods played by actors suspended on cranes to suddenly solve characters' problems. One sees this in all sorts of movies where problems are solved last minute by an outside entity. In the end of the not-so-acclaimed movie *Jurassic Park 3* the characters are saved by the U.S. Navy, and in the end of the even less acclaimed movie *Matrix 3*, Keanu Reeves is saved by a mysterious supercomputer named . . . Deus Ex Machina.

Not only is the *deus ex machina* popular in poorly written fiction, it is also popular in bad social science. In many social science and policy debates theorists think of potential problems and assume government can solve them (Demsetz, 1969). Although they do not view government law enforcement (regulators, police, and courts, which I will refer to as "the law") as a literal *deus ex machina*, most theorists view the law as exogenous corrective device. Whether the issue is security property rights or facilitating exchange, the idea is that government can and will fix problems.

Ellickson (1991, p. 138) uses "the phrase legal centralism to describe the belief that governments are the chief sources of rules and enforcement efforts." Legal centralism takes various forms, but all forms assume that markets would not be able to fully function without government rules and regulations.³ In addition to assumptions about the ability of markets to function without government, legal centralism includes assumptions about the efficacy of government. For Williamson (1983, p. 520), "Most studies of exchange assume that efficacious rules of law regarding contract disputes are in place and that these are applied by courts in an informed, sophisticated, and low-cost way. . . . The 'legal centralism' tradition reflects this orientation."

The strongest forms of legal centralism consider legal rules or regulation costless (notice, for example, that the Securities and Exchange Commission almost never mentions the costs of its policies), while weaker forms of legal centralism recognize some costs of legal rules or regulations but still consider them absolutely necessary. For Ellickson (1991, p. 138), "The quintessential legal centralist was Thomas Hobbes, who thought that in a society without a

2. Abel (1954) argues that Euripides's use of the *deus ex machina* plot device is not a fault but an excellence that intends to get the audience to think about the secular versus the divine. Abel may be right to defend Euripides specifically, but I doubt whether he would defend the use of the *deus ex machina* plot device in movies starring Keanu Reeves.

3. Legal centralism is found among various normative frameworks, among advocates of rights, utilitarianism, wealth maximization, and much else, regardless of one's support for markets or other political perspectives.

sovereign, all would be chaos,” but he argues that such thinking strongly influences law and economics scholarship today: “The seminal works in law and economics hew to the Hobbesian tradition of legal centralism.” My professors James Buchanan and Gordon Tullock are often skeptical of government in general, yet they ultimately follow Hobbes and believe that government enforcement is essential for markets. As Buchanan (1975, p. 163) writes, “The protective state has as its essential and only role . . . one of enforcing rights to property, to exchanges of property, and of policing the simple and complex exchange processes among contracting free men.”

Classical liberals typically advocate two main functions for the government legal system: protecting property rights and enforcing contracts to deal with force and fraud. One could support one function but not the other (e.g., calling on government to protect property rights but relying on private mechanisms for facilitating exchange), but most believe government must do both. As Richard Epstein (1999, p. 285) comments, “Under its classical liberal formulation, the great social contract sacrifices liberty, but only to the extent that it is necessary to gain security against force and fraud. Perhaps we might go further, but surely we go this far.” Epstein suggests that one would be a “naïve visionary” to “believe that markets could operate of their own volition without any kind of support from the state.” Likewise, Rajan and Zingales (2004, p. 293) write, “Markets cannot flourish without the very visible hand of government, which is needed to set up and maintain the infrastructure that enables participants to trade freely and with confidence.” Such a sentiment is also found in Mises ([1927] 2002, p. 39): “The state is an absolute necessity, since the most important tasks are incumbent upon it: the protection not only of private property, but also of peace, for in the absence of the latter the full benefits of private property cannot be reaped.” And the sentiment is found in Kirzner (1985, p. 680), who writes, “Preservation of this fundamental framework of individual rights calls for government that protects these rights against potential enemies.”

The strongest forms of legal centralism consider property rights and exchange impossible without government enforcement, while weaker forms of legal centralism recognize property rights and exchange as possible without government enforcement, but believe they would be extremely limited. To authors such as North (1990), Landa (1994), Olson (1996), Frye (2000), and Soto (2000) advanced markets and sophisticated exchange crucially depend on government making them legal centralist in some ultimate sense. Soto (1989), for example, describes how most Peruvians live on private property that is not recognized in any government registry, but ultimately Soto (2000) believes that advanced markets would require government to codify these property rights. Similarly North (1990) and Olson (1996) recognize that exchange often occurs in absence of government enforcement (one need not use law to trade among families, friends, or close-knit groups), but ultimately they argue that sophisticated markets such as those in capital markets would

be impossible without government enforcement. A common prediction is that cooperation breaks down as groups become larger or more heterogeneous, or trade takes place through time (Landa, 1994, p. 60; Frye, 2000, p. 34). Although Frye (2000) recognizes that private governance is important, he believes that private governance must be ultimately be subordinate to and backed up by law and that advanced markets cannot work without law.

2.2. WHEN THE ASSUMPTIONS OF LEGAL CENTRALISM DO NOT HOLD

Legal centralism is a clean theory that lets people declare, “Here is how I would like the legal system to shape the world,” and is thus understandably popular. It does, however, rest on many theoretical and empirical assumptions, and if some of those assumptions do not hold, the theory may not be useful for understanding or shaping the world. Whether one likes it or not, “market augmenting” (Olson, 2000, p. xi) legal agents might not exist, be inaccessible, have diverging interests, or know too little to help out. Instead of assuming that government has the ability and interest to solve problems, we must look to see if certain conditions are met. Whenever a potential problem exists, one should ask the following questions:

Do regulators, police, and courts have the ability to solve the problem in a low-cost way?

Do regulators, police, and courts have the knowledge to solve the problem?

Do regulators, police, and courts have the incentive to solve the problem?

Where the legal centralist assumes that the answers to these questions will be yes, the researcher of private governance considers the possibility that regulators, police, and courts may be lacking in important ways. Knowledge and incentive problems exist (Barnett, 1998; Benson, 1990; Boettke, 2005, 2012; Hoppe, 1989; Pennington, 2011; Rothbard, 1973, 1977; Stigler, 1975; Stringham and Zywicki, 2011a). Whether one hopes for government to eliminate fraud, deal with principal-agent problems, protect property rights, or enhance markets in any other way, simply assuming government will solve the problem is a nonstarter. If the answer to one or more of the above questions is no, then unmet needs exist, and then we should ask:

When unmet needs exist, will the private sector have the ability, knowledge, and incentive to solve them?

In many cases there is no solution, and people just have to live with the problem. In many cases, however, private parties will notice problems and

look for solutions through private governance. The chapters in this book describe cases in which market participants clearly could not rely on regulators, police, and courts to solve their problems. This explains why parties need to turn to private governance. Thinking about institutional, Austrian, and public choice economic insights in the area of governance gives reasons to question the legal centralist approach.

2.2.1. Do Regulators, Police, and Courts Have the Ability to Solve the Problem in a Low-Cost Way?

“What? This \$25 long-distance phone card is bogus?” The thoughts “I’ve been had” and “This cannot be happening to me” raced through my mind. I contacted various law enforcement agencies and lawyers to initiate a lawsuit. For weeks I sat by the phone, but for some reason nobody returned my call. I have been living with this missing \$25 and devastation for the past two decades. . . . Actually I did lose \$25, but I never ended up making any of those calls. How much good would it have done? I could have assumed that relying on courts would have been relatively low cost. But assuming something so does not make it so. Because the cost of initiating a lawsuit, including the cost of my time, far exceeded what I reasonably could expect to get back, I preferred treating the \$25 as a sunk cost over spending time and money through avenues with little prospective gain. At the time I had no private solution either, but the fact that legal solutions are costly or often nonexistent should be the starting point of our analysis, as that reality shapes how individuals and businesses choose.

A \$25 phone card is trivial, but it’s actually the just tip of an iceberg. Each day trillions of small transactions take place, and although theoretically it is possible to take a party to court each time another party does not follow through with its part of the bargain, at a minimum doing so would be very costly. What percentage of transactions in your typical day do you think could be easily enforced in courts of law? Where would you even begin? Even the most litigious person must weigh the expected benefits of initiating a lawsuit (what you could be awarded times the estimated probability of winning the lawsuit) with the cost of hiring a lawyer and going to trial, the hassle of dealing with the courts, the value of your time, the inconvenience of having assets held up in the legal system, the negative repercussions of being seen as a litigious person, and so on. Whenever the cost of enforcement exceeds the value of what is at stake or what one can reasonably expect to gain through law, then private parties must simply live with the problem or seek private solutions.⁴

4. I am not arguing that the many litigious parties and million lawyers in the United States do not exist. Their mere existence, however, does not prove that they are augmenting markets. Instead, many simply are using the state according to Bastiat’s ([1848] 1995) description, in which “The state is that great fiction by which everyone tries to live at the expense of everyone else.”

How significant are the costs of formulating, implementing, complying with, and enforcing rules (Hertog, 1999, p. 225)? How significant are the costs of hiring lawyers, going to trial, having facts verified and interpreted, and after the trial, getting the party in the wrong to rectify the situation (Barzel, 2002; Bernstein, 1992; Hart and Moore, 1999; Klein and Leffler, 1981; Telser, 1980; Tirole, 1999)? The costs of using courts are often significant, and whenever they outweigh what is at stake in a lawsuit, most people will not bother with the law. Galanter (1981, p. 3) describes how “courts resolve only a small fraction of all disputes that are brought to their attention. These are only a small fraction of the disputes that might conceivably be brought to court and an even smaller fraction of the whole universe of disputes,” and transactions with disputes are but a fraction of the total number of transactions.

Shadow-of-the-state theories of order suggest that even if most transactions are not litigated, the prospect of litigation, punitive damages, or high fines makes the expected costs of bad behavior too high. Yet the greater the “transaction costs” of using various aspects of the law, the greater the likelihood that the legal system deviates from textbook ideals (Williamson, 1996, p. 142). That helps explain why even with high fines, government cannot stamp out drugs in society, or even prisons, and that helps explain why many petty fraudsters continue to exist even though fraud has been illegal since time immemorial.

The cost of using the legal system can be significant not just for small dealings but for large dealings as well. Businesses that have millions of dollars at stake in transactions or require fulfillment to move forward with business do not want to have assets tied up in government courts. When I worked on a trading desk in the late 1990s, we needed to make sure each poorly executed trade was rectified by the end of each day, not the end of the year. Our trading desk worked out dozens of potential problems daily, and not once did we or our counterparts initiate a lawsuit.

The cost of using the legal system can be significant not just for straightforward transactions but even more so for complex ones. In simple models two parties agree to exchange two assets, and government simply needs to verify whether each party delivered (Buchanan, 1975, p. 104). Sophisticated transactions, however, often involve complex bundles of goods that are not easily verifiable by third parties (Lancaster, 1966; Hart and Moore, 1999; Dore and Rosser, 2007). For example, a court can observe parts of a bundle, such as whether custom software was installed on customers’ machines, but be less able to evaluate the other more subjective and more important elements of the product. When goods have a thousand attributes (Microsoft Windows and Macintosh operating systems each have tens of millions of lines of code that interact with each other), government may be able to reasonably evaluate only a handful of them. How significant are the costs of writing contracts describing multifaceted and heterogeneous goods, stipulating the myriad of possible

contingencies (if that's even possible), remedies when specific performance is not met, or relying on the legal system to fill in these details (Barzel, 2002, p. 37; Lind and Nyström, 2007)? When was the last time you sued Microsoft or Apple when your computer crashed?

The cost of using the legal system may be significant only in a few areas, or it may be extremely widespread. One of the biggest markets is the labor market (according to some estimates, labor accounts for roughly 75 percent of national income [Gomme and Rupert, 2004]), yet Vandenberghe (2000, p. 541) describes it as being full of implicit contracts that are “too vague to be legally enforceable.” Have you ever worked with someone who shows up to work and follows all the rules but is not effective at actually producing value? Does law enforcement help businesses make unproductive employees more productive, or does it make it difficult for companies to fire them? If regulators, police, and courts do not have the ability to solve a problem in a low-cost way, then unmet needs will exist.

2.2.2. Do Regulators, Police, and Courts Have the Knowledge to Solve the Problem?

In fall 2011, thousands of protesters converged in downtown Manhattan through the Occupy Wall Street movement, demanding that government rein in and increase regulations on the financial sector. One list of demands at the website OccupyWallStreet.org (2011) called for everything from “outlawing credit rating agencies” to “immediate across the board debt forgiveness for all. Debt forgiveness of sovereign debt, commercial loans, home mortgages, home equity loans, credit card debt, student loans and personal loans now!” Despite the economic nature of most of their demands, a *New York Magazine* survey (Klein, 2011) of Occupy Wall Street protesters found that in response to the question “Who is the chairman of the Federal Reserve?” 42 percent answered “Don’t know” (only 38 percent could answer correctly), in response to “What is the ‘S.E.C.’?” 68 percent answered “Don’t know,” and in response to “What is the Dodd-Frank Act?” 84 percent answered “Don’t know.”⁵ For a movement that focuses on economic issues, protesters’ knowledge of economics (not to mention their knowledge about the importance of bathing at least once per month) does not appear to be that strong. Without irony, Harvard law professor and now U.S. senator Elizabeth Warren states, “I created much of the intellectual foundation for what they do,” and “I support what they do” (Johnson, 2011). Meanwhile, on the productive and better-dressed

5. For readers who did not live in the United States at the time of this survey, the correct answers were Ben Bernanke, the Securities and Exchange Commission, and a major set of financial regulations signed into law in 2010.

part of Wall Street, trillions of dollars of shares exchange hands. The masters of the universe on Wall Street could sit around and hope that the state will be a “market-augmenting government” that will “expand the dominion of markets by providing rules that facilitate voluntary and reliable trade” (Azfar and Caldwell, 2003, p. 3) and hope for “effective judicial enforcement of complicated contracts” (Glaeser, Johnson, and Shleifer, 2001, p. 854). Or they can recognize that government officials often lack an understanding of the markets they are allegedly bolstering. While private parties are figuring out how to make incredibly complex financial deals possible, government officials are debating banning short sales or imposing price controls on interchange fees (Zywicki, 2011).

Ludwig von Mises and Friedrich Hayek argue that government is not omniscient and that without markets in consumer and producer goods, central planners cannot calculate whether the value of what they are producing is worth more than its costs (Hayek, 1945; Mises, [1920] 1990; Salerno 1990).⁶ Hayek describes the market as a discovery process in which different people get to test out different ideas and see what best fulfills customer desires. Profits and losses provide constant feedback about whether firms are serving their customers, but such feedback is absent with government. Although Hayek used terms such as *discovery* to describe the process of common-law judges figuring out the best legal rules, he did not entertain the idea that all rules and regulations be subject to the market test (Stringham and Zywicki, 2011). But what if he did? How will a monopolist government best identify problems, and how will it know where to devote scarce resources? How will government measure the costs of additional rules and regulations, and how will it measure the potential burden they impose on subsequent parties? What is the likelihood that the government designs and enforces rules in an optimal way, and what is the feedback mechanism when it does not solve problems or makes problems worse? Just as the central planner assumes that without property rights, prices, profits, and markets the government can engage in rational economic calculation, the legal centralist assumes that government, a monopolist legal and regulatory system, can effectively weigh the effects of each rule to prevent problems in markets. If regulators, police, and courts lack the knowledge of what rules or enforcement procedures are augmenting markets and what are harming them, then unmet needs will exist.

6. For example, a road might be valuable, but without knowing the opportunity cost of the inputs (stone, cementing agents, labor, and land) or the value of the road to consumers, government can only guess whether the road is worth more than what otherwise could be produced. With markets, producers can see the prices all of their inputs and outputs, which enable them to calculate whether it makes sense to produce any given product or to produce it in a different way. Without markets, such feedback is absent (Mises, [1920] 1990).

2.2.3. Do Regulators, Police, and Courts Have the Incentive to Solve the Problem?

San Francisco has a lot of gentle people with flowers in their hair, but it also has a fair share of down-and-out drug addicts. I remember walking down the aisle in the Safeway grocery store across from the San Francisco Giants' ballpark, AT&T Park, and observing a man lying flat in the middle of the aisle, staring up into the air.

Several employees came over, thinking he had fallen. "Are you okay?" one asked.

"Yes, I am completely fine."

"May we help you get up?"

"No, there is no problem whatsoever. What is the problem?" he asked, bothered that they were asking questions of a normal person simply minding his business. In his drug-influenced alternate universe there was no problem with him lying there for hours, but to a high-volume grocery store each minute of his presence meant lost sales in the short run and fewer customers in the long run. To Safeway, matters like this are a potentially big problem.

When something is a big problem to a merchant such as Safeway, especially to a merchant that pays so much in taxes, one could assume that government police will set their priorities accordingly. But the San Francisco Police Department has other priorities. Even a well-meaning government police force has to prioritize its time, and no matter how important the issue is to Safeway, the police can lack incentives to cater to Safeway's needs. In San Francisco, the police classify a merchant call about removing an unwanted guest as a low-priority event and usually will not send anyone at all.

James Buchanan and Gordon Tullock asked economists to consider the possibility that government agents consider their well-being when making decisions. Buchanan never applied public choice to law (instead Buchanan [1975] describes government enforcement mechanistically, like an alarm clock acting), but what if he did? A weak version of the public choice hypothesis is that law enforcement officials care about the public but also consider their own well-being when making choices. They might like protecting property rights or facilitating economic exchange on other people's behalf but not be very motivated, in the same way that many government teachers work, but not as hard as they could. A stronger version of the public choice hypothesis is that law enforcement officials care about their personal well-being and not that of their subjects. Police objectives can include relatively benign failings such as keeping patrolling to a minimum, consuming leisure, or pursuing overtime, or more malevolent failings such as using the law to extract resources or exert power. Legal centralists' wishes notwithstanding, law enforcement officials may not have maximizing utils in society or maximizing Kaldor-Hicks efficiency in their objective function.