

YOUR KINDLE NOTES FOR:

Private Governance: Creating Order in Economic and Social Life

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32 Highlight(s) | 0 Note(s)

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> 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.

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> 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.

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> 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.

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> already create and enforce rules. The amount of private governance in current society is far greater than people commonly recognize and governance can be analyzed as a club good that can be provided in a multitude of ways. Merriam-Webster defines a club as “an association of persons for some common object usually jointly supported” or “an association of persons participating in a plan by which they agree to make regular payments or purchases in order to secure some advantage.” How people with common goals meet their needs together is an often unexplored question. Clubs allow members to opt into preferred governance structures, and they create incentives for cooperation within. The simple ability to screen or exclude unwanted members gives clubs a powerful tool to discourage bad behavior without relying on the use of force. Competing clubs must constantly prevent or alleviate potential problems in ways that their members prefer. Private governance harnesses the benefits of

> competition, experimentation, and constant feedback that are seen in markets but not in government.

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> Many economists concerned with Kaldor-Hicks efficiency (wealth maximization as measured in dollar terms) argue that rules are needed to deal with externalities (spillover benefits or spillover burdens not captured or paid for by the decision-maker) because private parties lack incentives to internalize costs they impose on others (Musgrave, 2009). Those concerned with rights (Stringham and White, 2004) could reframe the problem as saying that rules are necessary wherever rights violations—including property rights violations—are likely to occur. But most interactions take place between parties at a small enough scale that such “externalities” can either be internalized or have the potential rights violations be dealt with within a club. Even though they have many members, golf clubs, colleges, and stock exchanges have a strong incentive to solve the problem of potential “externalities” within their realms (Foldvary, 1994).

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> In the first century of equity trading, the degree of financial innovation was considerable even though most financial instruments were outlawed by the state. The market was neither a simple spot market nor a small market in which everyone had familial or religious ties. It involved large transactions through time and fluctuations that could have tempted parties to default. Despite the many potential complications, brokers abided by their contracts not because of legal compulsion but because of private mechanisms.

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> Although Kirzner asserts that one of the institutional prerequisites of markets is “enforceability of contract” and without it “the market cannot operate” and that therefore “those institutions cannot be created by the market itself” (Kirzner, 2000, p. 83),2 my research about the history of stock markets shows that the rules of the stock market emerged from the market.

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> The rules of the stock market came from brokers themselves as they transformed coffeehouses into private clubs to create and enforce rules. Government officials were neither particularly knowledgeable about modern economics and finance nor particularly interested in the well-being of stockbrokers. The stockbrokers, however, both understood and cared about the problems they faced, so rather than sitting around and waiting for nonexistent government solutions, they took the initiative and altered what economists call the microstructure of the market (O'Hara, 1995; Carlos and Neal, 2006; Neal and Davis, 2005, 2006). Brokers experimented with ways to notify each other about defaulters, fines, entrance fees, subscription fees, and membership requirements. Their ultimate enforcement mechanism ended up being exclusion of anyone who did not meet certain requirements or follow the rules.3 Brokers experimented with various rules and finally documented them in 1812 in what they described as a "collection of laws … for the government of the members" (Committee for General Purposes of the Stock-Exchange, 1812, p.

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> organization. The London Stock Exchange shows that the rules of one of the most important and sophisticated markets, the stock market, were generated privately rather than from the state.

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Yellow highlight | Page: 98

> incentives to provide them. Brokers from nineteenth-century New York and twentieth-century London realized they could make their market more attractive by screening firms, creating listing requirements, and requiring disclosure for investors. The requirements were not decided by government, but by the market participants themselves, win or lose, based on the attractiveness of their venue. Those that failed to adopt good rules or that adopted burdensome rules were at a competitive disadvantage, and those that adopted good ones succeeded. Rather than taking part in "a race to the bottom" in which anything goes, the New York Stock Exchange

> worked to make its market attractive and only put its stamp of approval on firms that warranted trading. One of the main reasons for the success of the New York Stock Exchange and the more recent success of AIM is their effective systems of private regulation. Each offers a different set of private rules and regulations and caters to different market segments.

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Yellow highlight | Page: 102

> particularly pronounced. At the height of PayPal's initial ascent, U.S. Attorney General Janet Reno (2000) recognized that government enforcement against cybercrime was ineffective. She stated that for government to be able to stop online fraud, it must have the following technological and legal capabilities: (1) "a round-the-clock network of federal, state, and local law enforcement officials with expertise in, and responsibility for, investigating and prosecuting cybercrime"; (2) "computer forensic capabilities, which are so essential in computer crime investigations"; (3) "adequate legal tools to locate, identify, and prosecute cybercriminals, and procedural tools to allow state authorities to more easily gather evidence located outside their jurisdictions"; and (4) "effective partnerships with other nations to encourage them to enact laws that adequately address cybercrime and to provide assistance in cybercrime investigations."2 If government is deficient in any of these ways, it can lack the ability to effectively enforce laws against fraud.

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Yellow highlight | Page: 104

> In settings with high degrees of anonymity, advanced technology, and interaction across political boundaries, private parties must look elsewhere than government. As Thiel stated, "On the positive side, if we had not come up with a technology solution to fraud, we would have simply gone out of business. [Government] might have arrested various low-level people, but we would never have gotten the money back." Most of PayPal's solutions are behind the scenes, so they are often unappreciated by users or social scientists.

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Yellow highlight | Page: 106

> PayPal solved an important problem, and it was rewarded. Before

> PayPal began in late 1999, more than 90 percent of eBay auctions were paid using checks (Schwartz, 2001). Only half a year later, more than 1 million daily auctions on eBay were advertising PayPal as a method of payment. Purchased by eBay for $1.5 billion in 2002, PayPal now has 109.8 million accounts and processes more than $118 billion in transactions per year (Sengupta, 2012). The company's fraud loss rate is an industry-leading 0.5 percent (PayPal, 2012).

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Yellow highlight | Page: 108

> A loss from fraud is quantifiable, just like any other loss, and firms will take steps to minimize such a loss, just like any other. A firm that can reduce losses for itself captures those benefits, and a firm that can help reduce losses for others can market those benefits to others. PayPal and CyberSource are cases in point. The private sector did not need to look into academic debates about whether fraud management was a public good. Instead these companies saw fraud management as a service that can be priced and sold, thereby filling in a "missing market" in this realm.

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> In a high-technology world with relatively anonymous interaction across political boundaries, government's ability to deal with fraud is quite limited. PayPal, and likely most electronic commerce, would not exist had it depended on government to enforce contracts over the Internet. When PayPal realized that it could not rely on government to rectify occurrences of fraud, it found many ways to minimize problems before they occurred.

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> Frye (2000) argues that social cooperation without government breaks down under conditions when a population is heterogeneous or has high discount rates. Both of those conditions were met in San Francisco. Residents came from elsewhere in America, Australia, Chile, China, England, Germany, Mexico, Peru, and the Sandwich Islands (Hawaii). Eighty percent were single males (Soule, Gihon, and Nisbet, 1854, p. 488), and many wanted to get rich quick from gold. Helper (1855, p. 238, p. 37) writes, "Villains from all parts of the world

> swarmed upon the new soil," and "Words fail us to express the shameful depravity and unexampled turpitude of California society." Bancroft (1887, p. 94) describes gangs "entering various saloons and demanding drink and cigars; if not instantly and cheerfully produced, the rioters would go behind the bar, help themselves and their associates, then smash a few decanters and mirrors." As is common, there was a problem and no government interest or ability to solve it.

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Yellow highlight | Page: 117

> Yet bar owners and others did not want to be subject to bands of marauding gangs. Having one's customers beat up or one's property smashed is not exactly a good business model. Bancroft (1887, p. 97) writes, "Fear took hold on the money-makers, and indignation; they swore in their hearts that these things should not be." The January 24, 1850, Daily Alta California states, "Our merchants must organize some system of private watchmen." Because the private sector had needs that government clearly did not meet, it decided to create a system of private police.

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Yellow highlight | Page: 119

> protecting. For example, government police cared little about policing Chinatown, yet an 1854 article in the Daily Alta California (p. 2) reports that the Chinese neighborhood near Sacramento Street "is kept scrupulously clean by the special policeman on that beat, and no portion of the city is more quiet and orderly at night. This, however, has been the work of the Chinese themselves, in putting themselves voluntarily under the supervision of a special policeman, and no praise is due to the city." The government even proposed outlawing private police because too much gambling occurred in Chinatown, but the private police did not seem concerned about prohibiting consensual acts. The government, in contrast, was never friendly to the Chinese and passed various laws against them, including the 1862 "Act to protect free white labor against competition with Chinese coolie labor, and to discourage the immigration of Chinese into the State of California." Government certainly was not on the side of minorities, as critics of private police such as Benjamin (2009) assume, but here the private sector really did come to the rescue when matters for Chinese residents got bad:

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> Despite the theory that “it would obviously not be feasible, if indeed it were possible, to deny the protection provided by … police … to those who did not voluntarily pay” (Olson, 1965, p. 14), private police have figured out ways to get funding. The most obvious of all is—drum roll please—to provide police services to paying customers! Simply look at the placards indicating that a property has subscribed to a Patrol Special Police firm (figure 8.3). If a property owner wants the luxury of a Patrol Special Police officer checking on the business at night or rushing to the scene in the case of a problem, one has to be a customer.

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Yellow highlight | Page: 127

> in point. Similarly, the “private” security contractors in Iraq ultimately are hired, directed, and financed by the U.S. government, so in these cases one should not be surprised that they act against rather than to protect the Iraqi people. Government decisions to contract out work should not be considered outcomes of the free market (Benson, 1994b; D’Amico, 2009).

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Yellow highlight | Page: 135

> The political leaders eventually wanted new police, but recruiting and training replacements would take months, and by August 2005 the 4.5-million-inhabitant nation contained only 2,500 police.1 After they fired 30,000 police, did chaos ensue? One Georgian told me, “I did not notice any difference in crime, except I actually felt safer because I did not have to worry about being robbed by the police” (personal interview, Bakuriani, Georgia, August 8, 2012). The president stated, “People thought that we would have disaster.… Nothing like of this sort has happened because what it proved was that this police was not producing order, it was producing disorder” (Saakashvili, 2005). Although standard neoclassical theory teaches that “all prescriptions of behavior for individuals require enforcement” (Stigler, 1970, p. 526), in Georgia people refrained from killing each other, not because of government but for private reasons.

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Yellow highlight | Page: 138

> But in Theory of Moral Sentiments, Smith describes reasons why individuals adopt constraints and govern themselves. Smith ([1759] 1853, p. 235) believes that if we do something that our moral faculties judge as wrong, “Those vicegerents of God within us, never fail to punish the violation of them, by the torments of inward shame, and self-condemnation; and on the contrary, always reward obedience with tranquility of mind, with contentment, and self-satisfaction.” Smith considers these constraints as internal; the only punishments are shame or self-condemnation. The person with a conscience does not want to have to think about the questions “How can you live with yourself?” and “How can you sleep at night?”

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> Because individual self-governance lies within, it is less easily observable than other economic factors, but just because something is difficult to observe does not mean that it does not exist. Research in economics, psychology, and anthropology indicates that individual self-governance is important.

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Yellow highlight | Page: 141

> The anthropologist Henrich and more than a dozen collaborators conducted behavioral experiments in fifteen small-scale societies around the world, and they found that people’s likelihood of acting cooperatively (or prosocially, in the authors’ terminology) instead of like Homo economicus varies across societies. Henrich and coauthors (2005, p. 795) write, “We found, first, that the canonical model—based on pure self-interest—fails in all of the societies studied.” Regardless of where they were from, people were much less likely to behave opportunistically than orthodox neoclassical theory predicts. But, as one would expect, some people cooperated more than others. One of the researchers’ most interesting findings is that “the higher the degree of market integration” in a society, “the greater the level of prosociality expressed in experimental games” (2005, p. 795).10 This is consistent with McCloskey’s (2006) view that markets make people more moral or perhaps that fence sitters find it easier to act morally in a market economy. The causality may go the other way, but

> markets and morality seem to go hand in hand (Storr, 2009; Langrill and Storr, 2012).

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Yellow highlight | Page: 152

> accuracy). Consider the following potential benefits of arbitration: 1. Flexibility 2. Low cost or cost efficiencies 3. A speedy outcome and avoidance of undue delay 4. "Fairness" and "justice" 5. Legal due process 6. Results comporting with commercial, technical, or professional standards 7. Predictability and consistency in result 8. A final and binding resolution 9. Privacy and confidentiality 10. The preservation of a relationship and continuing performance (Stipawowich, 2010, p. 53) Given that trade-offs exist, which ones are most important, and what is the optimal combination? The person who "knows" the optimal solution for all people, is a legal centralist. The neatness of the legal centralist solution notwithstanding, law and economics scholars should recognize that different people have different preferences and that the optimal solution will vary depending the wishes of the parties involved. In contrast to a government one-size-fits-all solution (Hasnas, 1995), private adjudication lets the parties select the priorities, which will vary based on the needs and wants of each party.

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Yellow highlight | Page: 183

> Markets are supposed to consist of informed, nonfraudulent relationships, so does the occurrence of multi-billion-dollar fraud prove the necessity of government regulation? The first point to highlight is the fact the Securities and Exchange Commission had a $1 billion annual budget and conducted eight investigations of Madoff over the years, yet it "failed to follow incriminating evidence in plain sight" (Stout, 2009, p. B1). In late 1999 a private analyst named Harry Markopolos was asked by his firm to see if it could replicate Madoff's returns. Madoff claimed his "split strike conversion" strategy made money from owning stocks that track an index, selling out of the money call options to generate income, and buying put options to limit downside losses. Selling calls and buying puts associated with stocks is actually the common "using collars" strategy that limits both the downside and upside potential of owning stocks (Gaffen, 2008). Markopolos's firm actually had a fund that followed such a strategy, and within five minutes Markopolos concluded that Madoff's returns

could not exist. Within four hours he demonstrated this mathematically (Markopolos, 2009, pp. 7–9). In 2000 Markopolos and colleagues sent a report to the Securities and Exchange Commission stating that “the entire fund is nothing more than a Ponzi Scheme” (Kotz, 2009, p. 7) and followed up with additional complaints, including Markopolos’s 2005 report to the Securities Exchange and Commission titled “The World’s Largest Hedge Fund Is a Fraud.” Others, including Barron’s, publicly questioned how Madoff could have annual returns averaging 15 percent, with extremely low variance, and never have a down year (Arvedlund, 2001). Another industry writer, Ocrant (2001, p. 1), also discussed Madoff’s skeptics, who were “baffled by the way the firm has obtained such consistent, nonvolatile returns month after month and year after year.” When the Securities and Exchange Commission asked Madoff how he could make such high returns, Madoff responded, “Some people feel the market. Some people just understand how to analyze the numbers that they’re looking at” (Kotz, 2009, p. 19). After the fraud was exposed, the inspector general of the Securities and Exchange Commission concluded, “Because of the Enforcement staff’s inexperience and lack of understanding of equity and options trading, they did not appreciate that Madoff was unable to provide a logical explanation for his incredibly high returns” (Kotz, 2009, p. 19). A reliable assumption is that most government officials lack an understanding of financial markets in general, and reading the full 450-page report from the inspector general of the Securities and Exchange Commission confirms it in this case. The first lesson is that government simply lacked the knowledge or incentive to notice this massive Ponzi scheme.

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Yellow highlight | Page: 187

Social “Security” is underfunded (Kotlikoff, 2012). I have no respect for Madoff, but he at least had decency to trick investors into his fraudulent scheme, rather than force investors to hand over their money or force workers to “invest” 12.4 percent of all earnings in a retirement scheme. After he was exposed, he also at least had the decency to admit he was a fraud rather than continue to tell people he is investing in their future. In contrast to government, private governance lets people hire others to do due diligence, pay for various levels of production, and opt into structures of governance that they prefer. Despite examples of fraud here and there, the hedge

> fund market is as safe as it is not because of government but because of an advanced system of private checks.

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Yellow highlight | Page: 199

> Readers who have not had to deal with financial or business regulations are invited to read the Code of Federal Regulations. At 150,000 pages, it's wildly interesting reading and not too hard to keep up with: just read one hundred pages each day, and you can get through the existing set of regulations in five years, and hope that they haven't added too many others by the time you are done. Many of my friends work as compliance officers on Wall Street, and they say that although the regulations all but guarantee them employment, they would not wish the regulations on their worst enemy.

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Yellow highlight | Page: 213

> Hayek suggests that the role of a particular judge in the common-law system is analogous to that of the gas station owner in the market system. Although it appears that a judge "makes" the law, Hayek argued that in reality the common-law judge is simply doing what the gas station owner does: articulating or announcing the outcomes of an underlying spontaneous order process, not actually "making" the law. This is the notion in which Hayek argued that judges "discover" the law rather than making it.9 Hayek wrote:

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Yellow highlight | Page: 217

> Hayek views governmental judge-made law as a proper scope of government and a crucial element of spontaneous order—whereas the content of the law can arise spontaneously, the institutional infrastructure of courts cannot be left to competition and spontaneous order processes. But Hayek also grants to the government another important power: he grants the legislature the ability to alter the law when common law reaches a "dead end" through adherence to precedent. Hayek delegates this responsibility to legislatures because in his scheme the role of the judge is to uphold expectations and engage in an imminent criticism of the law by making new rules and situations cohere within the existing infrastructure of rules. Thus, where a well-established rule is thought

> to be obsolete and reform is needed, it is inappropriate for judges to adopt a new rule that would disrupt settled expectations. Legislatures, however, can legislate prospectively and thereby essentially create new expectations, rather than making decisions based on settled expectations. Hayek emphasizes, however, that when legislatures engage in this sort of rule-making they should act in a fashion consistent with the abstract purpose-independent nature of common-law rules (cosmos) rather than the command-oriented nature of many legislative rules (taxis). He also supports legislation when the law develops in ways that are inconsistent with the market economy. Ultimately, Hayek believed in a system of law that builds on precedent and emerges and changes slowly over time, but when it reaches a dead end, he says, the legislature is justified in intervening to remove the bad precedent and prospectively set the legal system onto a new and better track. To Hayek it is the best of all worlds: reliance on individuals who use accumulated knowledge and operate within a greater framework to ensure that the market persists. Individual judges could rely on precedent in law in much the same way that individual producers in markets rely on prices.

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Yellow highlight | Page: 218

> to do more" than discover the law. But his institutional structure is inadequate to ensure that judges in fact do no more and that they lack the power to do more than discover the law. Each of these two statements of the problem suggests a different challenge for Hayek: the first raises the knowledge problem as to the institutional circumstances under which judges can actually discover the law accurately, and the second raises an accountability problem regarding the agency-cost relationship between judges and society as to whether judges can be constrained to discover the law rather than pursue their own interests.

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Yellow highlight | Page: 221

> polycentrism. Hayek's theory rests on a radical decentralization and polycentrism of law in which courts are engaged in an ongoing, dynamic discovery process of experimentation, trial and error, and feedback. In fact, Hayek's vision of law seemingly pushes toward the less-hierarchical polycentric institutional structure of his friend Bruno Leoni ([1961] 1972, pp. 23–24), who argued that a "Supreme Court"

> with authority to issue top-down binding pronouncements on lower courts was actually an anomaly in a true common-law system. Leoni also argued that it would be possible to rely on entirely judge-made law rooted in custom and dispense with legislation completely—an argument that Hayek (1973, p. 68, n. 35) rejects with minimal explanation. If the legislature has the

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