Atl Econ J (2014) 42:171–180
DOI 10.1007/s11293-014-9407-5

Extending the Analysis of Spontaneous Market Order to Governance

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Published online: 16 March 2014

Abstract How much do markets depend on the state? The founders of the Austrian School of Economics saw a lot of room for markets but believed that government rules and regulations are needed to create framework for markets. More recent research, however, has shown that rules and regulations underpinning some of the most advanced markets such as stock markets have emerged from the market. This article discusses how Austrian economic insights about the importance of competition (although not atomistic competition), entrepreneurship, and consumer sovereignty can be applied to governance itself.

Keywords Private governance · Austrian economics

JEL P12 · P14 · B53

Introduction

How much do markets depend on the state? Austrian economists from Carl Menger and Eugen Böhm-Bawerk to Ludwig Mises and Friedrich Hayek argued that markets can effectively handle much more important functions than pretty much all non-economists and most economists assume (Boettke 1995; Salerno 2002). They discussed how people with seemingly different interests can actually coordinate through a market system. A system that relies on private property, prices, and profits and losses encourage people to work together and create an amazingly complex decentralized order, and the government need not design the system or direct individuals at every turn. At the same time, however, these same economists believe that the state plays a crucial role in creating the framework. Without government enforcing property rights and contracts, a market order could not emerge. Mises (1927/2002, p.39) writes: "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

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benefits of private property cannot be reaped." Hayek (1978) states, "Our spontaneous order of society is made up of a great many organizations, in a technical sense, and within an organization design is needed. And that some degree of design is even needed in the framework within which this spontaneous order operates, I would always concede; I have no doubt about this. Of course, here it gets into a certain conflict with some of the modern anarchists."[1] To these economists, the market may work wonders but markets have their limits and ultimately depend on the state.

But if one looks back in history, the rules for many of the most important markets came from markets. Since time immemorial government officials have had little understanding or respect for advanced financial markets, yet these markets emerged long before government was enforcing contracts therein. In the world's first stock market, in seventeenth century Amsterdam, government officials considered all but the simplest transactions as forms of gambling, and thus unenforceable. Nevertheless, an amazingly complex market with forward contracts, short sales, and options emerged (Stringham 2003). Likewise in eighteenth century London, government officials passed various prohibitions on the stock market, but brokers traded anyway and transformed coffeehouses into private clubs to create and enforce rules (Stringham 2002). Similarly the New York stock market emerged out of Tontine Tavern and Coffee House on Wall and Water Street and the brokers gradually adopted more rules for brokers and listing companies. Mises is quoted as saying that the most fundamental type of markets in a capitalist society is the stock market: "A stock market is crucial to the existence of capitalism and private property. For it means that there is a functioning market in the exchange of private titles to the means of production. There can be no genuine private ownership of capital without a stock market: there can be no true socialism if such a market is allowed to exist" (Rothbard 1995, p.426). Yet it turns out that the rules for this most fundamental market were created and enforced by what I will call private governance.

These are just a couple of the examples of private rules and regulations that economists have been documenting for the past couple of decades (Anderson and Hill 2004; Benson 1988, 1989, 1990, 1994, 1998; Bernstein 1992; Clay 1997; Curott and Stringham 2010; Ellickson 1991; Foldvary 1994; Greif 2006; Johnsen 1986; Landa 1994; Leeson 2007, 2008, 2009, 2014; Powell et al. 2008; Schaeffer 2008; Skarbek 2014; Smith 2014; Stringham 1999, 2007; Stringham and Zywicki 2011a, b).[2] I think it is accurate to say that among self-professed Austrian economists in America today, most believe that the rules and regulations for markets can be created by markets. The same may be true in some other countries. I just have less data and will not generalize here. One could argue that this new strand is a fundamental departure from the thinking

[1] Many American economists who cite these Austrians as influences hold a similar view. For example, Israel Kirzner (1985, p.680) writes, "Preservation of this fundamental framework of individual rights calls for government that protects these rights against potential enemies." Buchanan (1975, p.163) writes, "The protective state has as its essential and only role the enforcement of individual rights to property, to exchanges of property, and of policy the simple and complex exchange processes among contracting free men." And 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."

[2] Rothbard (1973) and Friedman (1973) were the first American economists to advance this line of thinking and empirical research in this topic followed soon after. For reviews of this literature see Boettke (2005; 2012); Casey 2012; Powell and Stringham (2009) and Stringham (2007).

of the original Austrian economists, and in an important sense that is right. The intent of this article is not to dehomogenize Mises and Rothbard, but to highlight this new strand of Austrian economics in America. This article focuses on how one can build upon the ideas of the original Austrian economists and conclude that something as fundamental as governance can be private.

Analyzing Governance as a (private) Club Good

Unlike certain neoclassical counterparts, Austrian economists never saw markets as atomistic or saw competition as requiring an infinite number of firms (Rothbard 1962, pp. 573–79). Once one recognizes that firms need not be infinitesimally small, one can notice market entities providing things that would be classified as a public good in Paul Samuelson's framework. In his "Economic theory of clubs," Buchanan (1965) makes the case that economists should not assume that goods are either pure public goods that need to be shared by everyone in society or pure private goods that can be consumed only by one person. Instead, all goods can be analyzed as club goods for which the "optimal" size of the club depends on each good. In this framework the optimal size of a club to consume an ice cream cone is usually one person, and the optimal size of a club to use a lighthouse (in theory but not in actuality [Coase 1974; Barnett and Block 2009]) might be infinite, a pure "public good." However, most goods fit somewhere in between. A club of a thousand people shares a golf course, and a club of a hundred people shares a swimming pool in an apartment complex.

In addition to sharing a golf course or a swimming pool, members of clubs share rules and view in this light that the rules are a club good. Rules can range from a dress code at the country club to actual rules of a specific road or set of roads. The same is true of other sources of private governance such as shopping malls, apartment complexes, and stock exchanges. Moving beyond the "government provision" versus "no provision" dichotomy reveals that many private organizations already create and enforce rules.

Clubs can be geographically based and have a comprehensive set of rules for many aspects of life (as in a boarding school or a kibbutz), or clubs can be made for solving problems at very small margins within one's life, such as a chess club. Whether they realize it or not, most people choose to be members of many various clubs created to solve problems in different areas. Vincent Ostrom (2007) and Elinor Ostrom (2005, p.283) discuss how governance can come from many sources with overlapping units (polycentrism), and their framework easily can be applied to clubs. For example, at any given time an individual can be a member of a geographically-based residential club with rules of conduct between members (what is often subsumed under tort law and criminal law) as well as a business club such as a stock exchange with rules about trading (what is often subsumed under contract law). Membership in a private club can be formal or informal, long term or short term. In any given day a person might frequent a gated community, an apartment complex, an office complex, a corporation, a shopper's club, a country club, and a nightclub. To the extent that rules or forms of security are beneficial, these clubs create and enforce rules within their realms. In many areas rule enforcing clubs already exist. In other areas, especially on government owned land, private enforcement could almost certainly exist if those areas were privatized or private provision were allowed.

Many economists argue that government must create rules to eliminate externalities, but it should be noted that most interactions already take place between parties on a small enough scale that such “externalities” can be internalized (or have the potential rights violations be dealt with) within a club.[3] 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). If the potential for externalities is greater, then the optimal size of a club can be greater. Geographically-based clubs can be as small as a store or as large as Disney’s Celebration, Florida (10,000 residents) or Las Vegas’s City Center, bigger than many towns in the United States with more than 5,000 hotel rooms (Clark et al. 2010). Non-geographically-based financial clubs such as MasterCard and Visa encompass billions of people (Stringham 1999). In government-managed property, there are no owners who have the incentive and ability to maintain or police the road. It is therefore not surprising to observe the market failing to provide security, but in shopping malls or other areas with private roads, private security is provided by the mall owner, paid for by tenant members, and free for guests. These markets do not meet the neoclassical conditions of perfect competition, but competition in these markets exists.

Analyzing Governance as a Product for Sovereign Consumers

Viewing governance as a club good lets one apply economic analysis of non-governmentally determined goods to this area. An important contribution of Mises was his discussion about how in markets consumers are sovereign (Mises 1949, p.269). Even though companies own the means of production and are officially in charge, they must continually work to figure out what consumers want and at the end of the day consumers decide which ones should be rewarded for serving them. The same is true of rule-enforcing clubs trying to attract members. Like consumers of other products, those who will be subject to a possible rule or bundle of rules can evaluate the expected benefits and costs of any given rule.[4] For example, a person considering joining a country club with a particular fashion rule weighs how much it will likely benefit him (the benefits of being around well-dressed people) against the potential level of inconvenience (the individual cost of having to be well dressed). A country club

[3] One could analyze clubs trading off the ease of solving problems within small groups (the fewer the members, the more likely the common interests) versus the amount of potential externalities between different groups (the greater the number of distinct clubs, the greater the need for interclub interaction). Musgrave (in Buchanan and Musgrave 1999, p.41) maintains that small groups can privatize the “external bads and goods” but believes “that solution, however, is not feasible where larger numbers are involved.” Individual clubs, just as with sovereign nations, might not have the individual ability to deal easily with global externalities, international disputes, or disputes between clubs. For those types of disputes, cross-club dispute mitigation and resolution mechanisms may be needed. But even if certain global “externalities” or other sovereignty issues exist, it does not therefore follow that global government will solve the problem (Cuzan 1979; Leeson 2007).

[4] In *Reason of Rules*, Brennan and Buchanan (1985) advocate applying economic analysis to analyze the costs and benefits of any given rule. Without unanimous political agreement or a hypothetical veil of ignorance behind which people make disinterested constitutional choices, one can debate how practical such a proposal is for evaluating rules that apply to all of society (Block and DiLorenzo 2000). Buchanan’s framework can be much more easily applied to club rules to which all club members agree.

considering adoption of such a rule will thus estimate how it would affect its members' satisfaction with their product.

This framework is applicable to any rule, including torts or fraud. A college considering adoption of a rule about noise levels in dormitories compares how much students value quiet with the potential inconvenience of having to be quiet. Similarly, a stock exchange considering adoption of an additional disclosure rule for its members must weigh how much the rule likely enhances the market versus its cost.

Yet some people argue that governance is different. When considering private governance, many people believe that those setting the rules will inevitably stack the deck in their favor or agree and change the rules after the fact. Authors such as Grigg (2010, p.282) write that "Regulatory programs should follow the principle of 'not having the fox guarding the chicken coop.'" This analogy implies that a stock exchange will create rules that help brokers at the expense of investors, an apartment complex will create rules at the expense of tenants, or a firm will create rules at the expense of its employees. The implication is that government, as a disinterested third party, is better suited to create rules than members of a given industry.

The idea that firms' interests are never aligned with those of their business partners should be rejected outright (after all, for whom are the producers producing?). It should be recognized that at any given instant trading partners' interests can diverge and this could pose potential problems in the realm of governance. Parties can agree to a contract that would be mutually beneficial if everything went according to the original plan. Yet after initiating the contract, one party might feel the desire to engage in post-contractual opportunism (Klein et al. 1978). This problem can be characterized as a prisoners' dilemma where both prefer the contract over no contract, but each one may choose to alter his half of the bargain. A cunning buyer wants to receive goods without paying, and a cunning seller wants to receive money without delivering. When both parties think this way, no transactions will take place.

Although the potential for non-cooperative outcomes is always real, the more that the parties can gain by cooperating, the greater the market incentive is for them to solve the problem (Klein 2002). In the prisoners' dilemma story, the two prisoners have no ability to communicate or coordinate their strategies in advance. In the real world, if parties can step outside the prisoners' dilemma, they often can eliminate many of the problems that arise only in one-shot anonymous situations (Tullock 1985, 1999). Both parties have an incentive to minimize their potential losses and maximize their potential gain. If they can coordinate to do so, they both gain.[5] This is not to imply that at any instant private governance (or any other system) has the ability to eliminate all problems. Consumers and providers of private governance do have incentives to find ways of minimizing the problems associated with opportunism. The more effective the solutions, the more they will be demanded by consumers. The same is true about the overall reliability and consumer focus of private governance.

Consider the incentives of a provider of private governance or any other service. The more that clients think they will be cheated after a relationship begins, the less willing they will be to begin that relationship (demand decreases as the value of the service decreases). On the flip side, the more likely it is that sellers think they will be cheated

[5] For example, in laboratory experiments in which parties can communicate and discuss strategies, the amount of cooperation is extremely high (Levy et al. 2011).

by a client, the less willing they will be to provide the service (supply contracts as the cost of providing the service increases). Introducing risks that shift the demand and supply curves inward hurts sellers and buyers alike. Akerlof (1970) describes this in his famous discussion of the lemon problem with used cars (if buyers think cars might be lemons, prices become low, and the result is that only sellers of lemons are in the market). Such issues do pose potential problems, but sellers have an incentive to eliminate them by providing assurances to buyers (Klein 2002; DiLorenzo 2011). In the car market, for example, sellers rely on various mechanisms such as repeat business, reputation, money back guarantees, third party verification, third party warranties, and leases in which the lessor, as the owner of the car, bears the long-run risk of any problem. Sellers have an incentive to assure buyers that they will get their money's worth.

Similarly, providers of private governance have an incentive to provide assurances that they will treat their clients well; otherwise, the demand for their product will not be as high as it could be. A stock exchange that fails to provide assurances or attempts to stack the deck in favor of its members at the expense of investors will attract fewer investors in its market in the long run. Any stockbrokers attempting to create rules that come at the expense of clients do so at their own peril. Likewise, an apartment building that has built-in risks for tenants will have decreased demand for its product in the long run. For the same reason that producers constantly develop ways to provide better products at lower costs, providers of private governance will seek to provide assurance to their clients. For example, not only must a developer of a condominium complex offer a physical unit that customers demand, but in the construction phase he must offer a contract with contingency clauses that the buyers can trust. He must also put in place the framework of the condominium association that will govern the property in the future. Without those, the demand for the product will be less. The incentives are quite similar for rental properties. Exceptions can occur, and in those cases one might want additional assurances that also can be private, but most of the time the producer has to be only pro-consumer.

Even if future customers are not present when private governance mechanisms are put in place, private governance providers must heed future customer demands. Thus, rather than being similar to a fox guarding a chicken coop, private governance is like a farmer guarding the chicken coop on behalf of egg buyers. Successful rules are crafted for the benefit of all constituents rather than at the expense of some. As in other product markets, ultimately the producer must work to please his clients (Mises 1949, p.358), making the relationship what Frederic Bastiat (1850) would call a harmony of interests rather than a conflict of interests. Like all market relationships, people will want to opt into a system of private governance only if the expected benefits are positive.

Analyzing Governance as Entrepreneurial Venture

Another contribution of Mises and Hayek is their discussion of how markets allow for continual variation, experimentation, and innovation to see what consumers want. People have different wants and their wants may change over time. A major advantage of markets is it allows for entrepreneurs to satisfy consumer wants in different ways. In the realm of governance, a market allows what could be described as a liberal archipelago (Kukathas 2007) of governance structures. Because clients are in the driver's seat, providers of private governance must constantly evaluate how a mechanism benefits and costs their clients.

Consider a stock exchange deciding whether to adopt a new rule that will likely decrease losses from fraud by one percent per year. Where the non-economist would say "adopt the rule,"[6] the exchange must evaluate the marginal benefits and costs of the rule from the perspective of member firms, brokers, and their ultimate clients, the investors. If investors ultimately bear the cost and benefits of rules and the total costs of drafting, enforcing, and complying with the rule (Hertog 1999) exceed the savings, the rule does not make sense. The decision is similar to that of an apartment building choosing not to hire a potentially useful armed guard who is extremely costly. The potential benefits and costs of new mechanisms for encouraging cooperation are not always clear, but private governance enables small-scale rather than society-wide social experiments for evaluating new mechanisms (Caplan and Stringham 2008). What mechanism is optimal? Private governance is not a government one-size-fits-all "solution," and it allows private governance providers to craft solutions that cater to the needs at hand (Hasnas 1995). Those who develop new solutions reap the immediate benefits of those choices, and in the long run this encourages others to mimic those good mechanisms and abandon bad ones.

Or consider the possible options for ensuring that parties follow through with their contracts. To the legal centralist, this is the realm of contract enforcement in which government (or private courts if one is a libertarian legal centralist) relies on enforcement of formal rules through the threat of *ex post* punishment. But parties already use many different mechanisms of private governance instead of government enforcement. These mechanisms can be formal, informal, long term, or short term. They can deal with problems *ex post* or help avoid problems *ex ante*. They can involve third-party enforcement or create incentives for self-enforcing contracts (Klein and Leffler 1981; Telser 1980). They can rely on the discipline of repeat dealings or on trust (Smith 1766; Macaulay 1963). Parties can give deposits to an escrow agent that can disburse funds (Friedman 2008, p.104) or hire a bonding or insurance agent that assumes the risk if any party does not follow through with his bargain. Parties can post irrecoverable assets (Williamson 1996), or they can use reputation bonds, the value of which are forfeited in case of default as a way of committing to cooperation (Greif 2006; Klein 1997; Stringham 2003). They can become a member of a club with strict membership requirements for upstanding merchants only (Stringham 2002), or they could even require membership in a close-knit clan or religious community (Landa 1994; Bernstein 1992; Johnsen 1986; Powell et al. 2008). Trading partners can be members of trading networks (Greif 2006; Clay 1997; Neal and Quinn 2001; Quinn 1997) or credit card associations (Stringham 1999) that act as a proxy for or guarantee of trust. They can have a system of informal or elaborate norms to encourage cooperation (Posner 2002).

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

[6] For example, Albert (2002) argues that if the rate of fraud in a private venue is greater than zero, then government must step in, yet she fails to discuss the expected costs of government enforcement or how government even has the capacity to reduce the amount of fraud, let alone reduce it to zero.

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.

Conclusion

Just as Menger, Mises, and Hayek applied economic analysis to something as crucial to markets as money, modern economists are applying economic analysis to governance. Rather than assuming governance is a public good that cannot be private, economists are analyzing governance as a club good and pointing out the prevalence of private options. In stock markets, and many other successful markets in history, the rules of these markets emerged from markets. The potential for cheating is always present, but for that reason market participants created rules to help prevent it. Private governance allows for variation, experimentation, and solutions that vary according to the challenges at hand. Private governance enables people to opt into the set of governance structures that they prefer rather than forcing the same set of rules on everyone in society. This research program is relatively new in the history of economics, but it is growing rapidly. As Boettke (2012, p.128) writes, "institutional analysis of situations of self-governance [or private governance] is not only an exciting intellectual endeavor, but perhaps the best way to advance the theoretical and methodological tradition of the Austrian School of Economics in the context of modern scientific economics."

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